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MARK S. POPOFSKY

#### The Section 2 Debate: Should Lenity Play a Role?

ABSTRACT. The Supreme Court's recent decision in *Illinois Tool Works*, by invoking the Rule of Lenity in construing the Sherman Act in a civil setting, raises a fundamental question concerning that statute: Should the theoretical possibility of criminal sanctions for monopolization offenses (Section 2 of the Sherman Act) narrow the Sherman Act in civil actions? Commentators have suggested that the answer might be yes. This Essay disagrees, and argues that lenity properly plays no role in judicial elaboration of the Sherman Act. Although the Supreme Court's insistence that a statute with both civil and criminal applications must mean the same thing regardless of enforcement setting appears to preclude different constructions of the Sherman Act depending on the selected enforcement tool, that merely raises the more fundamental issue of whether the Sherman Act is ambiguous in a lenity-triggering sense. The Essay demonstrates both that the Sherman Act's underlying Rule of Reason standard does not trigger the Rule of Lenity and that applying lenity to narrow the Sherman Act would not serve any of the Rule of Lenity's asserted purposes.

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#### INTRODUCTION

In its 2006 *Illinois Tool Works*<sup>1</sup> decision, the Supreme Court overturned the presumption of market power in antitrust patent tying cases. The result in *Illinois Tool Works* was widely expected. What the antitrust community did not expect, and what one notable antitrust Supreme Court practitioner called "striking," was the Court's invocation of "the rule of lenity that is applied in criminal cases" in civil *Illinois Tool Works*. The Rule of Lenity, a "basic axiom of federal criminal jurisprudence," provides "that a court should adopt the harsher of two rational readings of a criminal statute only when Congress has spoken in clear and definite language." In abrogating what it termed "a rule of severity for a special category of antitrust cases," the Court drew a contrast with "the normal rule of lenity that is applied in criminal cases" and emphasized that the same statutory text that establishes civil Sherman Act liability "makes the conduct at issue a federal crime."

By citing lenity in a civil setting in narrowing the conduct the Sherman Act condemns, *Illinois Tool Works* raises a fundamental methodological question concerning judicial elaboration of Sections 1 and 2 of the Sherman Act<sup>7</sup>: Does the Sherman Act's criminalization of conduct have implications for the statute's construction in civil cases,

Illinois Tool Works Inc. v. Independent Ink, Inc., 547 U.S. 28, 46 (2006).

Richard G. Taranto, Illinois Tool Works v. Independent Ink: A Lawyer's Take on Ending Special Suspicion of Patent Tying, 2 COMPETITION POLICY INT'L 169, 178 (2006).

<sup>3</sup> Illinois Tool Works, 547 U.S. at 45.

Dan M. Kahan, *Lenity and Federal Common Law Crimes*, 1994 S. Ct. Rev. 345, 345 (internal quotations omitted).

<sup>&</sup>lt;sup>5</sup> Illinois Tool Works, 547 U.S. at 45.

<sup>6</sup> Id. at 42.

<sup>&</sup>lt;sup>7</sup> 15 U.S.C. §§ 1-2.

particularly where the Act's application is unsettled?

Much might turn on the answer to this seemingly arcane question. According to one commentator, *Illinois Tool Works*' "invocation of the rule of lenity" is "of potentially quite general importance in the task of construing the Sherman Act, suggesting that doubts go against antitrust intervention in market activities." In other words, it is suggested, the Rule of Lenity might provide antitrust defendants with yet another weapon to argue for antitrust legal tests that tilt the scales against liability. Antitrust defendants might invoke lenity-based "doubts" to argue, *inter alia*, for safe harbors when Section 2 liability is unsettled, for exacting proof to demonstrate monopoly power, or even for an exacting default or baseline Section 2 legal test.

Whether lenity properly informs the Sherman Act's scope – and more particularly, whether it supports a presumption of non-intervention – is made particularly relevant by the continuing debate over the principles that inform judicial elaboration of Section 2 of the Sherman Act, a debate sparked by the government's case against Microsoft. A 2008 Department of Justice Report, according to its detractors, suggested an underlying framework for Section 2 that placed a thumb on the scale in favor of non-intervention. In withdrawing the Section 2 Report, the Obama-appointed head of the Antitrust Division specifically repudiated any such non-intervention presumption. Moreover, although the Supreme Court has clarified Section 2's reach in limited situations post-*Microsoft*, disagreement persists as to even the most basic questions concerning Section 2's

<sup>8</sup> Taranto, supra note 2, at 178.

See Pac. Bell Tel. Co. v. linkLine Commc'ns, Inc., 129 S. Ct. 1109 (2009); Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 549 U.S. 312 (2007); Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004).

underlying legal test and appropriate principles for its elaboration.<sup>10</sup> If, as some suggest, the Rule of Lenity creates a presumption against antitrust enforcement in a civil setting, that "basic axiom of federal criminal jurisprudence" could play an important role in resolving what some have some have called an "exclusionary conduct 'definition' war,"<sup>11</sup> perhaps tipping the scales toward non-intervention in many areas where Section 2's application is uncertain.

My purpose here is to explore the argument for applying the Rule of Lenity in resolving uncertainty concerning Section 2's substantive reach. Perhaps surprisingly, the invariably civil nature of modern Section 2 enforcement does not per force foreclose the Rule of Lenity. The reason is that criminal and civil liability spring from the same operative statutory language. As Justice Holmes observed a century ago, "the words cannot be read one way in a suit which is to end in fine and imprisonment and in another way in one which seeks an injunction." If the Rule of Lenity informs Section 2's substantive reach, that canon of construction likely applies even when that statute is enforced in a civil action. Whether lenity informs Section 2 legal tests therefore must be confronted directly.

I conclude that lenity has no proper place in resolving the continuing debate over Section 2. The Rule of Lenity is a canon of last resort, one that "comes into operation at the end of the process of construing what Congress has expressed" and "not at the beginning as an overriding consideration of being lenient to wrongdoers." Because

See generally Mark S. Popofsky, Defining Exclusionary Conduct: Section 2, the Rule of Reason, and the Unifying Principle Underlying Antitrust Rules, 73 ANTITRUST L.J. 435 (2006).

Andrew I. Gavil, Exclusionary Distribution Strategies By Dominant Firms: Striking a Better Balance, 72 ANTITRUST L.J. 3, 5 (2005).

Northern Securities Co. v. United States, 193 U.S. 197, 401 (1904) (Holmes, J., dissenting).

<sup>&</sup>lt;sup>13</sup> E.g., Russello v. United States, 464 U.S. 16, 29 (1983) (internal quotations omitted).

the Sherman Act is judicially construed to codify a standard of reasonableness (the Rule of Reason), and because Congress expected the courts to elaborate the Sherman Act in a common-law fashion, the Sherman Act – at least as a formal matter – arguably does not present a circumstance where courts "are left with an ambiguous statute." <sup>14</sup>

The poor fit between the lenity canon's asserted purposes and the Sherman Act reinforces the formal argument for elaborating Section 2 without regard to lenity. The Rule of Lenity, it is said, protects against unintended delegations of criminal law-making power from Congress to the courts. But construction of the Sherman Act to embody a rule of reasonableness that Congress expected courts to develop in a common-law fashion makes the Sherman Act an example of intended (even if implicit) delegation. Unless and until implicit delegation through case by case elaboration is deemed constitutionally impermissible, the Rule of Lenity is not properly deployed to police against it. Lenity purportedly helps constrain undesirable prosecutorial discretion. But the lack of any realistic threat of criminal Section 2 enforcement renders that concern inapplicable. Lenity assertedly helps ensure fair notice of what the law condemns. But if, as the Supreme Court has held, the Sherman Act's Rule of Reason provides constitutionally sufficient notice to defeat void for vagueness invalidity, fair notice concerns do not support invoking lenity to construe Section 2 narrowly.

Perhaps the most compelling rationale for lenity is that it helps ensure that criminal liability for so-called "regulatory" or *malum prohibita* crimes is confined to wrongful conduct; that is, absent unambiguous direction from Congress, statutes ought not be read to criminalize mere "errors" of judgment. But this concern, too, provides no warrant for applying the Rule of Lenity when determining Section 2's substantive reach. The *mens rea* element mandated by *United States v. United States Gypsum Co.*<sup>15</sup> confines criminal prosecution

Reno v. Koray, 515 U.S. 50, 65 (1995) (internal quotations omitted).

<sup>15 438</sup> U.S. 422, 435 (1978).

under Section 2 (however fanciful the possibility might be) only to "wrongful" (that is, malum in se) conduct. Indeed, Gypsum read the Sherman Act to contain a mens rea element in its criminal applications precisely because "the behavior proscribed by the [Sherman] Act is often difficult to distinguish from the gray zone of socially acceptable and economically justified business conduct." To invoke lenity to narrow Section 2's breadth when the Supreme Court imposed an intent requirement because of the statute's "indeterminacy" would turn Gpysum on its head.

Finally, a lenity-based presumption that doubts should go to the Section 2 defendants is unnecessary in light of the ability of Section 2 courts expressly to consider the risk of over- or under-deterrence in crafting appropriate Section 2 legal tests. In other words, precisely because the Sherman Act is a "charter of freedom" with the "generality and adaptability comparable to that found to be desirable in constitutional provisions," le lenity-based presumption against intervention is unwarranted. Substantive rules that tilt antitrust doctrine against intervention, if appropriate, ought to arise from sound antitrust decision-theoretic analysis, not from Congress's choice to enact a statute with both criminal and civil applications.

### I. STOCK ARGUMENTS IN THE EXCLUSIONARY CONDUCT DEFINITION WAR

Section 2 of the Sherman Act remains an antitrust flashpoint. A profound difference of views persists concerning the core principles that ought to guide Section 2's elaboration. Moreover, although the substantive legal tests that govern certain categories of conduct are

<sup>&</sup>lt;sup>16</sup> *Id.* at 440-41.

<sup>17</sup> Id. at 439.

<sup>18</sup> *Id.* (internal quotations omitted).

<sup>19</sup> See generally Popofsky, supra note 10, at 435.

settled, there is perhaps more about Section 2 that is undecided than decided. The legal tests that govern bundled discounts, loyalty discounts, and the proper measure of costs of predatory pricing cases are but some examples of the many questions concerning Section 2's application and operation that remain unresolved.<sup>20</sup>

The short life of the Antitrust Division's 2008 Report on Section 2<sup>21</sup> has sharpened the Section 2 debate. That Bush-administration Report suggested what many criticized as a "narrow" view of Section 2. Among other recommendations, the Report suggested applying a baseline "disproportionality" test when no specialized rule otherwise governed.<sup>22</sup> A majority of the FTC decried the Report as proposing a Section 2 defendant's paradise: "In short," three Commissioners wrote, "the Department's Report erects a multi-layered protective screen" for actual or would-be monopolists.<sup>23</sup>

The FTC majority soon found a like minded ally in Christine Varney, President Barack Obama's Assistant Attorney General for Antitrust. In her first major post-confirmation public address, AAG Varney withdrew the Section 2 Report, 24 declaring that it "raises [too] many hurdles to Government antitrust enforcement." In particular, AAG Varney disagreed with the Report's "skepticism regarding the

See generally Antitrust Modernization Commission, Report and Recommendations 84-94 (Apr. 2007) ("AMC Report"), available at http://govinfo.library.unt.edu/amc/report\_recommendation/amc\_final\_report.pdf.

U.S. DEPARTMENT OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT (2008; withdrawn May 11, 2009), available at http://www.usdoj.gov/atr/public/reports/236681.htm.

<sup>&</sup>lt;sup>22</sup> *Id.* Ch. 3.

Statement of Commissioners Harbour, Leibowitz, and Rosch on the Issuance of the Section 2 Report by the Department of Justice, at 10 (Sept. 8, 2008) ("FTC Statement"), available at http://www.ftc.gov/os/2008/09/080908section2stmt.pdf.

<sup>&</sup>lt;sup>24</sup> Christine A. Varney, Vigorous Antitrust Enforcement in this Challenging Era (May 11, 2009), available at http://www.usdoj.gov/atr/public/speeches/245711.pdf.

<sup>&</sup>lt;sup>25</sup> Id. at 6.

ability of antitrust enforcers – as well as antitrust courts – to distinguish between anticompetitive and lawful conduct" and its "related concern that failure to make proper distinctions may lead to 'overdeterrence." Resting on these flawed twin assumptions, AAG Varney continued, the Section 2 Report's "disproportionality" baseline produced a "preference for an overly lenient approach to enforcement." In place of the Section 2 Report, AAG Varney promised "[r]einvigorated Section 2 enforcement" that will "go 'back to the basics," taking as its loadstar "leading Section 2 cases" that include Lorain Journal, Aspen Skiing, 32 and Microsoft. 33

It is one thing for the Antitrust Division to cast aside the Section 2 Report. It is quite another to enshrine into law an approach that "look[s] closely at both the perceived procompetitive and anticompetitive aspects of a dominant firm's conduct, weigh[s] those factors, and determine[s] whether on balance the net effect . . . harms competition and consumers."<sup>34</sup> "[T]he U.S. courts have the final word; the antitrust agencies can choose to bring cases and argue new positions, but the final arbiter of the meaning of the antitrust laws is

<sup>&</sup>lt;sup>26</sup> Id.

<sup>&</sup>lt;sup>27</sup> *Id.* at 8.

<sup>28</sup> Id. at 9.

<sup>&</sup>lt;sup>29</sup> Id. at 10.

<sup>30</sup> *Id.* at 9.

Lorain Journal v. United States, 342 U.S. 143 (1951).

Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985).

United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001) (en banc) (per curiam).

Varney, supra note 24, at 13.

the federal judiciary."<sup>35</sup> And, as many observed upon the Report's withdrawal, the federal judiciary as a whole may be more sympathetic than not with the Section 2 Report's normative recommendations.<sup>36</sup> Section 2, moreover, is shaped largely in private litigation, where the courts' concerns with private treble damages actions (particularly class actions) can spillover into decisions that confine the antitrust laws' substantive reach. In particular, the Supreme Court has exhibited a reluctance to embrace an expansive role for Section 2 based in part with concerns rooted in private treble damages actions.<sup>37</sup>

In bringing Section 2 cases, federal enforcers can also expect to confront several now well-developed "stock" arguments that Section 2 defendants deploy precisely because such arguments can be (but are not always) persuasive to judges. These include:

• "It is all about price." Section 2 defendants frequently (although not always successfully) seek to characterize conduct as concerning price and thus properly analyzed under *Brooke Group*'s "below-cost plus recoupment" framework.<sup>38</sup> This includes most notably bundled and loyalty discounts.<sup>39</sup> The argument is even deployed to defend

Joe Sims, New Antitrust Chief Outlines Enforcement Philosophy (May 2009), available at http://www.jonesday.com/newsknowledge/publicationdetail.aspx? publication=6257.

<sup>&</sup>lt;sup>36</sup> See George L. Priest, The Justice Department's Antitrust Bomb, WALL St. J., June 2, 2009, at A21.

See, e.g., Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 414 (2004) (refusing to recognize antitrust duty to deal in part because private challenges would be "extremely numerous").

See Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 22-23 (1993).

Compare LePage's Inc. v. 3M, 324 F.3d 141, 151-52 (3d Cir. 2003) (en banc) (rejecting contention that Brooke Group governed analysis of bundled discounts) with Cascade Health Solutions v. Peacehealth, 502 F.3d 895, 919-20 (9th Cir. 2007) (adapting Brooke Group to bundled discount context).

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exclusive dealing: where competition for exclusives is possible, the argument runs, the "payment" for the exclusive obligation can be analyzed as a cost in a price/cost framework.<sup>40</sup>

• "It is really a refusal to deal." Another (sometimes) successful strategy is to position conduct as unlawful only if a court invalidates a refusal to deal. For example, suppose a firm conditions future deliveries of a key product to a distributor on that distributor not dealing with the firm's rivals. The firm surely would invoke Colgate<sup>41</sup> in defending its cutting off of that dealer (as to future deliveries only) as not implying an actual exclusive dealing obligation.<sup>42</sup> Another example is the price-squeeze theory recently dispatched by the Supreme Court in linkLine.<sup>43</sup> The Court reasoned that a price-squeeze claim, at least one that turns on the margin between wholesale and retail prices, could not get out of the

<sup>40</sup> See, e.g., NicSand, Inc. v. 3M Co., 507 F.3d 442, 451-54 (6th Cir. 2007) (en banc) (upfront payments for even multi-year exclusivity lawful when, inter alia, conceded not to amount to predatory pricing and when plaintiff failed to compete for the business). But see LePages, 324 F.3d at 157-58 (payments for sole source relationships formed part of conduct unlawful under Section 2); cf. Augusta News Co. v. Hudson News Co., 269 F.3d 41, 49 (1st Cir. 2001) ("Furthermore, the upfront payments were part of multi-year exclusive dealing contracts that might in principle be attacked under the rule of reason.").

<sup>41</sup> See United States v. Colgate & Co., 250 U.S. 300 (1919).

<sup>42</sup> Cf. United States v. Dentsply Int'l, Inc., 399 F.3d 181, 193 (3d Cir. 2005) ("Although the parties to the sales transactions consider the exclusionary arrangements to be agreements, they are technically only a series of independent sales. Dentsply sells teeth to the dealers on an individual transaction basis and essentially the arrangement is 'at-will.' Nevertheless, the economic elements involved the large share of the market held by Dentsply and its conduct excluding competing manufacturers realistically make the arrangements here as effective as those in written contracts." (citing Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752, 764 n.9 (1984))). Of course, such conduct nonetheless may violate Section 2, as in Lorain Journal.

<sup>43</sup> Pac. Bell Tel. Co. v. linkLine Commc'ns, Inc., 129 S. Ct. 1109 (2009).

starting gates absent a duty to sell at wholesale.<sup>44</sup> At least one court has applied *linkLine*'s logic beyond price-squeezes to exonerate a bundled discount.<sup>45</sup>

- "No causation." Wielding the antitrust equivalent of "if a tree falls in a forest and no one hears it, did it really fall?," Section 2 defendants frequently argue that causation is too attenuated to support antitrust liability. For example, the defendants in Rambus convinced the D.C. Circuit that deceptive conduct did not implicate Section 2 absent evidence that, but for the conduct, a standard-setting organization would have selected a different standard.<sup>46</sup>
- "Gains not worth costs." It is common for Section 2 litigants to frame arguments in decision-theoretic terms: given the risk of error and enforcement costs, attaching liability to particular conduct, the argument runs, likely would produce greater costs from false positives than from false negatives, and thus on balance over-deter procompetitive conduct. Although in principle a two-way ratchet, the Supreme Court recently has deployed the argument in favor of antirust defendants.<sup>47</sup>
- "When in doubt, courts should stay out." A variation of the false positive/false negatives argument is that free markets arrest

<sup>44</sup> *Id.* at 1119.21.

<sup>45</sup> See Doe v. Abbott Labs, 571 F.3d 930, 934-35 (9th Cir. 2009).

See Rambus Inc. v. FTC, 522 F.3d 456, 465-67 (D.C. Cir. 2008). But cf. United States v. Microsoft Corp. 253 F.3d 34, 79 (D.C. Cir. 2001) (en banc) (per curiam) ("To require that § 2 liability turn on a plaintiff's ability or inability to reconstruct the hypothetical marketplace absent a defendant's anticompetitive conduct would only encourage monopolists to take more and earlier anticompetitive action.").

<sup>47</sup> See Trinko, 540 U.S. at 411-15; linkLine, 129 S. Ct. at 1121-22.

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anticompetitive conduct more efficiently than antitrust courts. <sup>48</sup> Thus, the argument runs, when conduct is competitively ambiguous, courts should require particularly demanding showings to impose Section 2 liability. As reformulated by one commentator, it amounts to "an analytical starting point, a default position, that is a kind of Hippocratic oath for courts asked to intervene in private market activity: first do no harm." <sup>49</sup> This so-called "ethical prescription," <sup>50</sup> is the very presumption AAG Varney expressly disputed in shelving the Section 2 report.

This essay's purpose is to address yet another "stock" argument Section 2 defendants might wield: the Rule of Lenity. The Rule of Lenity, "a basic axiom of federal criminal jurisprudence," provides "that a court should adopt the 'harsher' of 'two rational readings of a criminal statute only when Congress has spoken in clear and definite language." As one commentator has noted, if this venerable canon of construction applies to "the task of construing the Sherman Act," it "suggest[s] that doubts go against antitrust intervention in market activities." That is, the canon potentially would reinforce the so-called "ethical prescription" of non-intervention, but perhaps more strongly dictate pro-defendant outcomes. I demonstrate below that, although the Rule of Lenity theoretically could be relevant to construing this nation's antirust laws, there are sound reasons why it ought not inform the scope of Section 2.

#### II. THE RULE OF LENITY: ANOTHER ARROW IN SECTION 2

<sup>&</sup>lt;sup>48</sup> See Frank H. Easterbrook, Does Antitrust Have a Comparative Advantage?, 23 HARV. J. L. & PUB. POLICY 5, 8 (1999).

<sup>&</sup>lt;sup>49</sup> Taranto, supra note 2, at 180.

<sup>50</sup> Id.

Kahan, supra note 4, at 345 (internal quotations omitted).

Taranto, supra note 2, at 178.

#### **DEFENDANTS' QUIVER?**

A. Civil Enforcement of Section 2 Does Not Per Force Defeat Lenity

One rightly might ask why one dredges up the Rule of Lenity in the context of crafting Section 2 legal tests. After all, the Antitrust Division has not brought a criminal Section 2 case since the late 1970s.<sup>53</sup> The Division's guidelines for criminal prosecution suggest there may never be another.<sup>54</sup> Section 2 enforcement in the United States thus exclusively is a civil affair. And if there is a relevant world-wide trend, it is to *de*criminalize "dominance" offenses.<sup>55</sup>

See United States v. Braniff Airways, Inc., 453 F. Supp. 724 (W.D. Tex. 1978) (conspiracy to monopolize indictment). According to one study that examined Antitrust Division enforcement from 1955 to 1997, the Division brought 6 criminal monopolization actions from 1955 to 1974; however, the same tables list 62 non-merger criminal "exclusionary" practices cases (which also include such cases brought under Section 1) during the same period, with two more from 1975-79. See Joseph C. Gallo et al., Department of Justice Antitrust Enforcement, 1955-1997: An Empirical Study, 17 REV. OF INDUS. ORG. 75, 95 (2000).

See Antitrust Division Manual at III-20 (Dec. 2008) ("In general, the current Division policy is to proceed by criminal investigation and prosecution in cases involving horizontal, per se unlawful agreements such as price fixing, bid rigging, and customer and territorial allocations."), available at http://www.justice.gov/atr/public/divisionmanual/atrdivman.pdf. This may leave open potential criminal conspiracy-to-monopolize prosecutions when the conduct also amounts to per se Section 1 violations; but the Division Manual seems to foreclose indictments under Section 2 when the conduct also would not violate Section 1.

Canada in 1986 replaced its long-standing but little-enforced statute that criminalized monopolization offenses with a civil statute that prohibits abuse of dominance, see A. Neil Campbell and J. William Rowley, The Internationalization of Unilateral Conduct Laws - Conflict, Comity, Cooperation and/or Convergence?, 75 ANTITRUST L.J. 267, 289 n.105 (2008), and in 2009 removed criminal sanctions from certain price-related offenses, including for predatory pricing, see Budget Implementation Act, 2009 S.C., c. 2, §§ 413 & 417

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The Rule of Lenity's application to the Sherman Act warrants attention because of a relatively new line of Supreme Court cases that address how to construe a statute, such as Section 2 of the Sherman Act, where criminal and civil liability spring from the same operative text. From this line of cases two principles appear to emerge. First, such "selfsame" language must mean the same thing no matter the

(Can.) (repealing Competition Act, R.S.C., ch. C-34), §§ 50 ("Illegal trade practices"), 51 ("Allowance"), and 61 ("Price Maintenance") (1985)). Criminal enforcement of antitrust laws at the state level appears confined to offenses that would constitute per se violations of Sherman Act Section 1. See generally ABA SECTION OF ANTITRUST LAW, STATE ANTITRUST ENFORCEMENT HANDBOOK 110.28 (2d ed. 2008) (describing state criminal antirust enforcement). jurisdictions (notably Australia and South Africa) criminalize cartel behavior but not "abuse of dominance" offenses. See Trade Practices Amend. (Cartel Conduct Measures) Act 2009. No. 59. 2009. ofhttp://www.comlaw.gov.au/ComLaw/Legislation/Act1.nsf/0/BF85AF568EC41235C A2575EC0017F479/\$file/0592009.pdf; Republic of South Africa Competition Act No. 89 of 30 November 1998 (last amended in Competition Second Amendment Act. No. 39 of 2000). Article 74, available at http://www.compcom.co.za/assets/ Files/pocket-book-2004-R.pdf. Some newly-enacted antitrust regimes lack any criminal sanctions, see Egypt (Law No. 3 of 2005, the Law on the Protection of Competition and the Prohibition of Monopolistic Practices of February 15, 2005, Art. 22); Republic of Macedonia (Law on Protection of Competition (2005), Art. 47, amended by Official Gazette of Republic of Macedonia no. 22/07, Art. 8.); Poland (The Act of 16 February 2007 on Competition and Consumer Protection, Art. 106); Trinidad and Tobago (Fair Trading Act of 2006, § 44(2)); and Uruguay (Ley N° 18.159 de 20 de julio de 2007, Arts. 17 & 19). But cf. Ugolovnyi Kodeks [UK] [Criminal Code] art.178 (Russ.), available at http://www.russian-criminalcode.com/PartII/SectionVIII/Chapter22.html (criminal penalties dominance offenses); Ryan Davis, Russia Opens Door to Criminal Antitrust Penalties, Law360, Nov. 5, 2009, available at http://www.law360.com/articles/132 700. By contrast, a few jurisdictions' criminal provisions extend to "dominance" offenses (including those of France, Ireland, Japan, and the Slovak Republic), but in practice these provisions are not enforced. See International Competition Network, Report on Tying and Bundled Discounting, June 2009, at 6, n.13, available at http://www.internationalcompetitionnetwork.org/uploads/library/doc 356.pdf.

enforcement setting (the "textual identity" principle). Second, canons of construction applicable to determining the meaning of a statutory proscription in a criminal setting are equally applicable when construing the same text in a civil action (the "lowest common denominator" corollary). Put simply, because statutory language means what it means, the Rule of Lenity – if applicable – must be considered no matter how the statute is enforced.

The Supreme Court's recent decision in Clark v. Martinez<sup>56</sup> illustrates both principles. There, the Court considered the government's authority to detain an inadmissible alien under 8 U.S.C. § 1231(a)(6). The Court held the matter governed by its prior decision in Zadvydas v. Davis,<sup>57</sup> which construed the key statutory phrase "may be detained beyond the removal period" to impose certain requirements as applied to one statutorily enumerated category of aliens.<sup>58</sup> Although Clark itself involved another such category, the prior construction, the Court reasoned, must control "without differentiation to all three categories of aliens."<sup>59</sup> Importantly, the Court rejected the government's argument that Zadvydas' construction of the phrase "may be detained beyond the removal period"<sup>60</sup> did not govern because, although Zadvydas involved a circumstance that warranted invoking "the canon that statutes should be interpreted to avoid constitutional doubts,"<sup>61</sup> the particular facts in Clark did not.<sup>62</sup>

<sup>&</sup>lt;sup>56</sup> 543 U.S. 371 (2005).

<sup>57 533</sup> U.S. 678 (2001).

<sup>&</sup>lt;sup>58</sup> Clark, 543 U.S. at 377.

<sup>&</sup>lt;sup>59</sup> *Id.* at 378.

<sup>&</sup>lt;sup>60</sup> *Id.* 

<sup>61</sup> Id. at 379.

<sup>62</sup> Id. at 380 ("The Government, joined by the dissent, argues that the statutory purpose and the constitutional concerns that influenced our statutory construction in Zadvydas are not present for clients, such as Martinez and Benitez, who have not been admitted into the United States.").

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The Court reasoned that, if the constitutional avoidance canon informed the meaning of statutory language in one setting, the construction compelled by that canon governed in all settings:

It is not at all unusual to give a statute's ambiguous language a limiting construction called for by one of the statute's applications, even though other of the statute's applications, standing alone, would not support the same limitation. The lowest common denominator, as it were, must govern.<sup>63</sup>

Clark's "lowest common denominator" principle has straightforward implications for the Rule of Lenity's application when construing statutes that can be enforced both civilly and criminally: if the statute can be enforced civilly or criminally, a limiting construction in the criminal setting dictated by the Rule of Lenity would equally apply when construing the statute in a civil action. Indeed, Clark cited two instances where the Supreme Court stated that "the rule of lenity" applies when construing a statute in a non-criminal setting "because we must interpret the statute consistently, whether we encounter its applications in a civil or criminal context."

<sup>63</sup> Id.

One commentator suggests to the contrary based on the apparent premise that, if the "least common denominator" principle applies, statutes such as the Sherman Act and other statutes might be undesirably narrowed. See Jonathan Marx, How To Construe A Hybrid Statute, 93 VA. L. REV. 235, 264-65 (2007). The premise is flawed. Identifying a "least common denominator" does not require the conclusion that such a denominator requires resort to lenity. On the contrary, as explained below, the Sherman Act as a formal matter is not ambiguous in a lenity-triggering sense. Marx ultimately reaches the same conclusion through a slightly different path: accepting the textual identity principle, Marx argues for lenity's applicability based on whether the statute's primary applications are civil or criminal. See id. at 275.

<sup>65</sup> Clark, 543 U.S. at 380 (quoting Leocal v. Ashcroft, 543 U.S. 1, 11-12 n.8 (2004)); see also Marx, supra note 64, at 264-65 (invoking United States v. Thompson/Center Arms Co., 504 U.S. 505, 517-18 (1992) (plurality), and id. at

One, United States v. Thompson/Center Arms Co., 66 is particularly instructive. There, as one commentator observed, "the Supreme Court endorsed for the first time the idea that the lenity canon could apply to a civil statute if that statue had criminal applications."67 The Court construed – in a civil setting – a statute in the National Firearms Act which imposed a \$200 tax on anyone "making" a "firearm." After concluding the statutory terms were ambiguous, a majority of the Court invoked the Rule of Lenity to "interpret a tax statute" in "a civil setting" because the statute has "criminal applications." In response to the dissent's contention that lenity did not apply because the action before the Court was civil. the plurality responded that lenity "is a rule of statutory construction whose purpose is to help give authoritative meaning to statutory language. It is not a rule of administration calling for courts to refrain in criminal cases from applying statutory language that would have been held to apply if challenged in civil litigation."70 To put the point in Clark's later language, because language means what it means, the "lowest common denominator" governs. The other case Clark cited, Leocal v. Aschroft. 71 is to the same effect: because the statutory term "crime of violence" had criminal applications, the Court reasoned, the

<sup>519 (</sup>Scalia, J., concurring)). One Justice who has not endorsed the textual identity principle nonetheless has acknowledged that the principle is embraced by a majority of the Supreme Court. *See* United States v. Santos, 128 S. Ct. 2020, 2032 (2008) (Stevens, J., concurring) (recognizing that a majority of the Court required "a single definition" of the statutory term at issue).

<sup>66 504</sup> U.S. 505 (1992).

<sup>67</sup> Marx, *supra* note 64, at 257.

<sup>68 26</sup> U.S.C. § 5849.

<sup>69</sup> Thompson/Center, 504 U.S. at 517-18 n.10; id. at 519 (Scalia, J., concurring) (also invoking Rule of Lenity).

<sup>&</sup>lt;sup>70</sup> *Id.* at 517-18 n.10.

<sup>&</sup>lt;sup>71</sup> 543 U.S. 1 (2004).

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Rule of Lenity applied to construing that ambiguous term in a civil setting.<sup>72</sup>

The "textual identity" principle" and its "lowest common denominator" corollary would seem to compel construing the substantive prohibitions of the Sherman Act, including Section 2, the same way in a civil or criminal setting. Section 2 of the Sherman Act, as with Section 1, proscribes a crime:

#### Section 2. Monopolizing trade a felony; penalty

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$100,000,000 if a corporation, or, if any other person, \$1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court.<sup>73</sup>

Today, as noted, Section 2 is enforced solely through civil actions. Civil enforcement of Section 2, however, is a consequence of *other* provisions of the Sherman Act.<sup>74</sup> Whether conduct violates Section 2 civilly or criminally requires applying a single statute's "selfsame

<sup>&</sup>lt;sup>72</sup> *Id.* at 12 n.8.

<sup>&</sup>lt;sup>73</sup> 15 U.S.C. § 2.

See 15 U.S.C. § 4 (providing that "it shall be the duty of the several United States attorneys ... to institute proceedings in equity to prevent and restrain violations"); 15 U.S.C. § 15 (private right of action to recover for injury to "business or property"); 15 U.S.C. § 26 (private right of action for injunctive relief). See generally United States v. Cooper Corp., 312 U.S. 600, 607 (1941) (observing that "Sections 1, 2 and 3 impose criminal sanctions" while "Section 4" both grants jurisdiction and authorizes equity proceedings").

language."75

Therefore, under the "textual identity" principle, Section 2's text arguably must mean the same thing regardless of enforcement setting. As Justice Holmes famously remarked in *Northern Securities* with respect to the Sherman Act, "the words cannot be read one way in a suit which is to end in fine and imprisonment and in another way in one which seeks an injunction." And, as the line of cases culminating in *Clark* illustrates, under the "least common denominator" corollary, if a canon of construction — such as the Rule of Lenity — requires a limiting construction when Section 2 is enforced criminally, that limiting construction is equally applicable to Section 2's reach in civil actions.

Two recent cases lend support to these conclusions. The first, United States v. Nippon Paper Co., 77 concerned whether Sherman Act Section 1, when enforced criminally, reaches wholly foreign conduct. Two prior decisions, United States v. Aluminum Co. of America and Hartford Fire Ins. Co. v. California, 79 stood for the proposition that the

<sup>&</sup>lt;sup>75</sup> 2 PHILLIP E. AREEDA AND HERBERT HOVENKAMP, ANTITRUST LAW ¶ 303, at 28 (2d ed. 2000).

Northern Securities Co. v. United States, 193 U.S. 197, 401 (1904) (Holmes, J., dissenting). Notably, the Areeda/Hovenkamp treatise disagrees with this conclusion, without explanation. See 2 AREEDA, supra note 75, ¶ 303, at 28 n.2.

<sup>&</sup>lt;sup>77</sup> 109 F.3d 1 (1st Cir. 1997). The author argued *Nippon Paper* for the United States.

<sup>&</sup>lt;sup>78</sup> 148 F.2d 416 (2d Cir. 1945) ("Alcoa"). In Alcoa, the Second Circuit sat as a court of last resort pursuant to 15 U.S.C. § 29. Thus, the Supreme Court has since treated Alcoa's precedential value as enhanced. See American Tobacco Co. v. United States, 328 U.S. 781, 811-12 (1946) ("That case was decided by the Circuit Court of Appeals for the Second Circuit under unique circumstances which add to its weight as a precedent."). But cf. linkLine, 129 S. Ct. at 1120 n.3 (declining to follow Alcoa's price-squeeze analysis as inconsistent with modern antitrust principles).

<sup>&</sup>lt;sup>79</sup> 509 U.S. 764 (1993).

Sherman Act had such reach in civil actions.<sup>80</sup> The First Circuit in *Nippon Paper* confronted whether the Sherman Act's territorial scope as developed in *Alcoal Hartford* equally applied to a criminal indictment. The First Circuit answered in the affirmative largely based on the textual identity principle: "common sense suggests that courts should interpret the same language in the same section of the same statute uniformly, regardless of whether the impetus for interpretation is criminal or civil."<sup>81</sup>

Having held that the Sherman Act's "trade or commerce . . . with foreign nations" language means the same thing when enforced civilly or criminally, the First Circuit confronted the argument that the Rule of Lenity nonetheless warranted reading that (assertedly ambiguous) language more narrowly in a criminal case. Implicitly endorsing the "least common denominator" principle, the court rejected the contention. "In view of the fact that the Supreme Court deems it 'well established' that Section One of the Sherman Act applies to wholly foreign conduct," the court reasoned, "we effectively are foreclosed from tying to tease an [Rule of Lenity-triggering] ambiguity out of Section One relative to its extraterritorial application." 82

In concluding that "the rule of lenity plays no part in the instant case," the First Circuit did not inquire whether *Alcoa* or *Hartford* applied, or should have applied, the Rule of Lenity in construing the

As the First Circuit "sum[med] up, the case law now conclusively establishes that civil antitrust actions predicated on wholly foreign conduct which has an intended and substantial effect in the United States come within Section One's jurisdictional reach." Nippon Paper, 109 F.3d at 4. See generally Mark S. Popofsky, Extraterritoriality in U.S. Jurisprudence, in 3 ISSUES IN COMPETITION LAW AND POLICY 2417 (ABA Section of Antitrust Law 2008).

Nippon Paper, 109 F.3d at 4. How the additional mens rea requirement for criminal liability required by Gypsum squares with the textual identity principle is discussed below.

<sup>82</sup> Id. at 8.

Sherman Act's territorial reach in a civil setting.<sup>83</sup> But that proves the point. The textual identity principle foreclosed later application of the Rule of Lenity in *Nippon Paper* when an earlier action (whether civil or criminal) established the statutory text's authoritative meaning. It follows that, if the Rule of Lenity applies, it must be considered no matter what the enforcement setting – as *Clark* put it, "[t]he lowest common denominator, as it were, must govern."<sup>84</sup>

The Supreme Court's decision in *Illinois Tool Works*<sup>85</sup> implicitly is to the same effect. The Court in *Illinois Tool Works* revisited the presumption of market power for patented products applied by many courts in tying claims brought under Section 1 of the Sherman Act. The *Illinois Tool Works* Court found in its 1947 *International Salt*<sup>86</sup> decision a "presumption of *per se* illegality of tying arrangement[s] involving a patented product"<sup>87</sup>; for a number of reasons, the Court held the presumption unwarranted absent proof of "market power in the tying product."<sup>88</sup>

One ground the Court gave for overturning *International Salt's* "patent-equals-market-power presumption"<sup>89</sup> was Congress's 1988 narrowing of the patent misuse defense to require "market power in the relevant market" for patent tying to constitute misuse.<sup>90</sup> The Court reasoned:

<sup>&</sup>lt;sup>83</sup> *Id.* For an analysis of the First Circuit's reliance on *Alcoa/Hartford* as illustrating potentially undesirable "path dependence" in construing statutes with both civil and criminal applications, see Marx, *supra* note 64, at 254.

<sup>84</sup> Clark v. Martinez, 543 U.S. 371, 380 (2005).

<sup>85</sup> Illinois Tool Works Inc. v. Independent Ink, Inc., 547 U.S. 28 (2006).

<sup>86</sup> International Salt Co. v. United States, 332 U.S. 392 (1947).

<sup>87</sup> Illinois Tool Works, 547 U.S. at 40.

<sup>88</sup> Id. at 46.

<sup>89</sup> *Id.* at 41.

<sup>90 35</sup> U.S.C. § 271(d)(5). See Illinois Tool Works, 547 U.S. at 42-43.

While the 1988 amendment does not expressly refer to the antitrust laws, it certainly invites a reappraisal of the *per se* rule announced in *International Salt*. A rule denying a patentee the right to enjoin an infringer is significantly less severe than a rule that makes the conduct at issue a federal crime punishable by up to 10 years in prison. It would be absurd to assume that Congress intended to provide that the use of a patent that merited punishment as a felony would not constitute "misuse." <sup>91</sup>

In other words, and echoing Nippon Paper, the Court reasoned that the Sherman Act's language means the same thing no matter the enforcement setting. After all, Illinois Tool Works involved a civil suit under Sherman Act Section 1; the comparison the Court drew between misuse and criminal sanctions would be inapposite if the meaning of Section 1's language could differ depending on whether a court applied it in a civil or criminal case.<sup>92</sup>

In addition to applying the textual identity principle, the Supreme Court also implicitly endorsed the "lowest common denominator" principle. In the course of dispatching the Respondent's arguments in support of *International Salt*, the Court noted that the U.S. antitrust enforcement agencies "in the exercise of their prosecutorial discretion" no longer endorsed the patent market power presumption.<sup>93</sup> "While that choice is not binding on the Court," a unanimous Court continued, "it would be unusual for the Judiciary to replace the normal rule of lenity that is applied in criminal cases with

<sup>91</sup> Illinois Tool Works, 547 U.S. at 42 (citations omitted).

The Supreme Court similarly invoked the possibility of criminal Sherman Act enforcement for minimum vertical resale price maintenance in overturning Dr Miles' century old per se rule. See Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 127 S. Ct. 2705, 2722 (2007).

<sup>93</sup> Illinois Tool Works, 547 U.S. at 45.

a rule of severity for a special category of antitrust cases."<sup>94</sup> This contrast only makes sense if the Rule of Lenity (if applicable) informs the Sherman Act's meaning in a civil setting.

To be sure, the Court's lenity-based comparisons do not amount to a holding that the Rule of Lenity actually *does* apply to, or compels particular constructions of, the Sherman Act.<sup>95</sup> The key point, rather, is that *Illinois Tool Works* recognizes that, because the Sherman Act defines a crime, principles of statutory interpretation that inform the construction of criminal statutes equally apply when considering the Sherman Act's reach in a civil setting.

When Clark's "lowest common denominator" principle is combined with Nippon Paper and Illinois Tool Works, the upshot is this: it is only a matter of time before defendants in civil antitrust cases invoke the Rule of Lenity in support of narrow rules of substantial antirust liability. The Sherman Act defines a crime; the language means the same thing whether enforced civilly or criminally; therefore, the argument runs, if the Rule of Lenity would compel particular substantive outcomes were the conduct challenged criminally, the same construction of Section 2 is required in a civil action.

#### B. How Might the Rule of Lenity Inform Section 2?

The above establishes that the Rule of Lenity is a potential weapon in a Section 2 defendant's arsenal. It takes little imagination to predict the lenity-based arguments that Section 2 defendants might

<sup>94</sup> Id.

On the contrary, as explained below, the Rule of Lenity plays no proper role in construing Section 2.

Of. Marx, supra note 64, at 265 (specifically noting that "[t]he effectiveness of, for example, civil antitrust statutes might be seriously impaired if courts were forced to construe them as parsimoniously as they would be compelled to do by a strong rule of lenity").

deploy. Where, the argument might run, Section 2's proscription of particular conduct is not settled – a very broad area of gray given the Supreme Court's caution that Sherman Act "cases must be read in the light of their facts and of a clear recognition of the essential differences in the facts of those cases, and in the facts of any new case to which the rule of earlier decisions is to be applied" or courts ought not declare conduct unlawful unless clearly anticompetitive. As one commentator formulated the contention, the Court's "invocation of the rule of lenity" in *Illinois Tool Works* is "of potentially quite general importance in the task of construing the Sherman Act, suggesting that doubts go against antitrust intervention in market activities."

A lenity-based doctrine that "doubts" are sufficient to defeat "antitrust intervention" would surely yield narrow constructions of Section 2. To take one of but many examples: the fundamental "default" or "baseline" legal test that underlies Section 2 – the doctrine to apply absent a safe harbor or other special rule – remains unsettled. Some argue for a narrow "profit sacrifice" test<sup>99</sup>; others endorse a standard that inquires whether the Section 2 defendant engaged in conduct capable of excluding an equally efficient rival<sup>100</sup>; the now-withdrawn Section 2 Report endorsed a Rule of Reason test requiring anticompetitive harm to be disproportionate to benefits<sup>101</sup>; and still others, including the current majority at the FTC, appear to endorse a more general Rule of Reason test where anticipated harms need

Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563, 579 (1925); cf. Caribbean Broad. Sys. Ltd. v. Cable & Wireless PLC, 148 F.3d 1080, 1087 (D.C.Cir.1998) ("Anticompetitive conduct' can come in too many different forms, and is too dependent upon context, for any court or commentator ever to have enumerated all the varieties.").

<sup>98</sup> Taranto, supra note 2, at 178.

<sup>99</sup> See generally Section 2 Report, supra note 21, Ch. 3, Pt. III.B.

<sup>100</sup> See id. Pt. III.C.

<sup>101</sup> See id. Pt. III.D.

merely exceed anticipated benefits.<sup>102</sup> If lenity-based "doubts" defeat Section 2 enforcement, that would plainly favor the disproportionality test over the more general Rule of Reason as the default Section 2 legal test.

The Rule of Lenity might also influence more retail-level legal choices. For example, debate persists as to how to characterize and analyze so-called bundled and loyalty discounts. Some courts and commentators characterize the conduct as merely involving price, and therefore properly subject to a modified form of *Brooke Group*'s cost-based safe harbor. <sup>103</sup> Others, by contrast, propose analyzing certain types of bundled and loyalty discounts (*viz*, those that pose a particular threat of impairing the scale economy of rivals or raising their costs) under a more general Rule of Reason approach. <sup>104</sup> If lenity compels that "doubts" go to the Section 2 defendant, that might impel courts to accept the price-based characterization.

Yet another example involves "screens" such as foreclosure percentages for exclusive dealing. Many courts require over 40% foreclosure from exclusive dealing to entertain challenges to such arrangements under Section 1. 105 By contrast, courts largely have eschewed hard foreclosure thresholds in adjudicating Section 2 challenges to exclusives; these courts have reasoned that foreclosure that might be benign when imposed by a firm lacking monopoly power might nonetheless harm competition when achieved by a monopolist. 106

<sup>102</sup> See FTC Statement, supra note 23, at 5.

<sup>&</sup>lt;sup>103</sup> See AMC Report, supra note 20, at 99.

<sup>&</sup>lt;sup>104</sup> See id. at 95-96, 99 (summarizing testimony).

See, e.g., United States v. Microsoft Corp., 87 F. Supp. 2d 30, 53 (D.D.C. 2000), aff'd in part, rev'd in part on other grounds, 253 F.3d 34 (D.C. Cir. 2001) (en banc) (per curiam). See generally Jonanthan M. Jacobson, Exclusive Dealing, "Foreclosure," and Consumer Harm, 70 ANTITRUST L.J. 311, 329-34 (2002) (discussing caselaw).

See, e.g., United States v. Microsoft Corp., 253 F.3d 34, 70-71 (D.C. Cir. 2001) (en banc) (per curiam).

Consideration of the Rule of Lenity, however, might motivate courts to fashion more demanding foreclosure screens in the context of Section 2.

One can imagine many more variations on this theme: lenity-based "doubts" might inform how Section 2 courts determine legally-sufficient causation (favoring a stricter causation test than applied by many courts), calculate costs under *Brooke Group* (favoring the exclusion of costs when in doubt), delineate markets (favoring broader markets), assess entry barriers (favoring counting only so-called "Stiglerian" barriers to entry), or measure monopoly power (requiring higher share thresholds and more durable entry barriers).

Put more generally, a doctrine that lenity-based "doubts" favor non-intervention could cover judicial enshrinement of many of the normative recommendations proposed by the now-repealed DOJ Section 2 Report, resulting in the very "multi-layered protective screen for firms with monopoly or near-monopoly power" feared by today's FTC majority and inveighed by the current head of the Antitrust Division.

## III. WHY LENITY PROPERLY PLAYS NO ROLE IN IDENTIFYING THE CONDUCT SECTION 2 PROSCRIBES

The potential use of the Rule of Lenity to influence the application of Section 2 in a civil setting, therefore, must be met head on. But that simply raises the fundamental question: does a **proper** application of the Rule of Lenity compel a minimalist approach to Section 2? I believe the answer is no. Indeed, correctly applied, the Rule of Lenity should play no material role in the elaboration of Section 2 of the Sherman Act. The reasons, as just explained, do not lie in the civil nature of Section 2 proceedings; the textual identity principle, and its lowest common denominator corollary, appear to foreclose that argument. Rather, it can be argued that Section 2 of the Sherman Act, as a formal matter, is not ambiguous in the sense that

<sup>107</sup> FTC Statement, supra note 23, at 10.

triggers the Rule of Lenity. Moreover, the *mens rea* required for criminal conviction under Section 2 already serves the key function assertedly performed by the Rule of Lenity. Accordingly, applying that canon of construction to limit Section 2's reach would improperly narrow Section 2.

#### A. The Formal Answer: No Relevant Statutory Ambiguity

On its face, one might think Section 2 is plainly ambiguous in the sense that triggers the Rule of Lenity. Section 2 proscribes "monopolize[ation]," as well as attempts and conspiracies to "monopolize." As the numerous judicial efforts over the years to give content to "monopolize" demonstrate, the term hardly is self-executing. Similarly teeming with ambiguity is the Supreme Court's statement that the statutory term "monopolize" targets "the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident." 110

Yet, courts have not, as a descriptive matter, tempered Section 2's application with the Rule of Lenity.<sup>111</sup> Some scholars suggest that courts thereby simply ignore lenity.<sup>112</sup> This is neither normatively satisfying nor, after *Clark*, *Illinois Tool Works*, and *Nippon Paper*,

<sup>108 15</sup> U.S.C. § 2.

<sup>&</sup>lt;sup>109</sup> See generally Popofsky, supra note 10, at 438-44.

<sup>&</sup>lt;sup>110</sup> United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966).

<sup>111</sup> See, e.g., Einer Elhauge, Preference-Eliciting Statutory Default Rules, 102 COLUM. L. REV. 2162, 2201 (2002) ("Regulatory crimes like antitrust and securities violations are often defined with enormous ambiguity, yet the rule of lenity is rarely applied to them.").

See generally Note, The New Rule of Lenity, 119 HARV. L. REV. 2420, 2420 (2006) (noting that "[m]any [observers] claim that courts have stopped applying [the Rule of Lenity] altogether").

persuasive. Even if courts failed to consider the Rule of Lenity in the past, these decision appear to put the argument in play going forward, at least where Section 2's meaning or application remains unsettled. Formal reasons for the lenity's inapplicability to Section 2, therefore, must be found elsewhere.

At least two such arguments support refusing to apply the Rule of Lenity to Section 2. The Sherman Act often is described as a delegation by Congress to the federal courts of the power to develop competition law in a common-law fashion. 113 If, the argument runs, the Sherman Act effectively delegates to the courts the power to create common-law crimes, Congress has validly "opted out" of the Rule of Lenity. 114 Antitrust crimes in effect are defined not by the statute itself, but rather by congressionally intended judicial elaboration. 115 There is no need to resort to lenity because we know what the legislature intended: "it wanted courts to exercise judgment rather than narrow the statute and return it to the legislature."116 This argument, however, runs into a fundamental tenet of American constitutional law: "legislatures and not courts should define criminal activity."117 Even if no "formal bar to express delegation to courts" remains as a general matter "in contemporary law," 118 conceptualizing the Sherman Act to delegate powers to the federal court to develop sound competition-law principles fits uncomfortably with principles of legislative supremacy.

A second formal reason for the Rule of Lenity's inapplicability

<sup>113</sup> See, e.g., Elhauge, supra note 111, at 2203.

<sup>114</sup> See id. at 2202-03.

<sup>115</sup> See id.

Id. at 2203 (recognizing that the rule of lenity is "merely a default rule, and like all default rules this one should operate only if the relevant actor does not opt out of it").

<sup>&</sup>lt;sup>117</sup> United States v. Bass, 404 U.S. 336, 348 (1971).

<sup>118</sup> Kahan, supra note 4, at 355.

side-steps this problem by reformulating the scope of congressional delegation and invoking the Rule of Lenity's disfavored status in the hierarchy of the canons of construction. Lenity requires statutory ambiguity; but "what counts as 'ambiguity' for purposes of the rule" is a "question [that] does not answer itself." 119 Nonetheless, the Supreme Court has often stated that lenity "comes into operation at the end of the process of construing what Congress has expressed,"120 "not at the beginning as an overriding consideration of being lenient to wrongdoers,"121 and "applies only when, after consulting traditional canons of statutory construction, we are left with an ambiguous statute."122 In other words, the Rule of Lenity applies only if, after "seizing everything from which aid can be derived," a Court "can make no more than a guess as to what Congress intended."123 If application of other principles of construction gives clear meaning to otherwise unclear text, lenity-triggering ambiguity will not be found "merely because it [is] possible to articulate a [narrower] construction."124

Application of these principles to the Sherman Act arguably avoids a conclusion of lenity-triggering ambiguity because the statute has judicially been construed to require application of a particular

<sup>119</sup> Id. at 384.

<sup>&</sup>lt;sup>120</sup> Burgess v. United States, 128 S. Ct. 1572, 1580 (2008) (quoting Callanan v. United States, 364 U.S. 587, 596 (1961)).

<sup>&</sup>lt;sup>121</sup> Callanan, 364 U.S. at 596.

<sup>122</sup> Burgess, 128 S. Ct. at 1580 (quoting United States v. Shabani, 513 U.S. 10, 17 (1994)).

<sup>&</sup>lt;sup>123</sup> E.g., Reno v. Koray, 515 U.S. 50, 65 (1995) (internal quotations omitted). See generally Kahan, supra note 4, at 385-86.

Moskal v. United States, 498 U.S. 103, 108 (1990). For a description of the position, acknowledged to have "scant" support "in the case law," that the Rule of Lenity is "a one -way ratchet in the defendant's favor" that "compel[s] the judge to select the narrowest [plausible] interpretation," see Zachary Price, The Rule of Lenity as a Rule of Structure, 72 FORDHAM L. REV. 885, 889-94 (2004); see also id. at 899 (describing Moskals "view of lenity" as "cramped").

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substantive standard: the Rule of Reason.<sup>125</sup> As the Supreme Court explained in *Standard Oil* with respect to Section 1: "Thus not specifying, but indubitably contemplating and requiring a standard, it follows that it was intended that the standard of reason which had been applied at common law . . . was intended to be the measure used for determining whether, in a give case, a particular act had or had not brought about the wrong against which the statute provided." <sup>126</sup> Construing the Sherman Act to codify the common-law principle of reasonableness, the argument thus runs, means that "seizing everything from which aid can be derived," <sup>127</sup> no ambiguity in a lenity-triggering sense remains: We know what Congress wanted, which is for courts to apply reasonableness principles in a common-law fashion.

The Sherman Act as codified common law reasonableness avoids one defect of the delegation theory: the Rule of Reason at least specifies some standard (or, more precisely, generative principle), rather than directing courts entirely to make up what constitutes Sherman Act crimes. But the codified common-law theory of the Sherman Act raises another problem: is a statutory standard such as the Rule of Reason ambiguous in a lenity-triggering sense because (i) its content is indeterminate in its application (even if "reasonableness" is unambiguous in concept); and (ii) its content is dynamic: conduct that is unreasonable at one point may be judged reasonable in light of changed circumstances, or the other way around? After all, the Supreme Court has stressed, the Sherman Act condemns not "a particular list of agreements," but rather "particular economic consequence[s]" that might "be produced by quite different sorts of [conduct] in varying times and circumstances."128 Put more generally, the Sherman Act "invokes the common law itself, and not merely the

<sup>&</sup>lt;sup>125</sup> United States v. Standard Oil Co., 221 U.S. 1, 60-62 (1911).

<sup>126</sup> Id. at 60.

<sup>&</sup>lt;sup>127</sup> *Reno*, 515 U.S. at 65 (1995) (internal quotations omitted).

<sup>&</sup>lt;sup>128</sup> Bus. Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717, 731 (1988).

static content [as of] 1890."129

The Supreme Court's reasoning in Nash v. United States 130 strongly suggests that the answer is no. Speaking through Justice Holmes, the Nash Court rejected a void for vagueness challenge to Section 1 and to the conspiracy-to-monopolize provision of Section 2.131 The Court found "no constitutional difficulty in the way of enforcing the criminal part of the act." 132 construed to require applying the Rule of Reason, for two reasons - reasons that meet each of the abovedescribed concerns. First, the Court observed, the "statute" had "taken up" the "common law as to the restraint of trade." 133 That is, the Sherman Act carried forward principles and precedents developed in the common law, thereby providing notice of the conduct the law condemns. Second, and meeting the above-described "dynamic" concern, the Court noted that "the law is full of instances where a man's fate depends on his estimating rightly," such as the case where one might be convicted of manslaughter for driving negligently. 134 Thus, even if the Rule of Reason's application cannot always be predicted accurately in advance, the principle is precise enough to avoid constitutional invalidity on vagueness grounds. The statute supplies a "generative" principle by which Congress created "scores of distinct legal obligations" that are illuminated through judicial application.135

Although unconstitutional vagueness differs from statutory

<sup>129</sup> Id. at 732.

<sup>130 229</sup> U.S. 373 (1913).

<sup>&</sup>lt;sup>131</sup> *Id.* at 377-78.

<sup>132</sup> Id. at 378.

<sup>133</sup> Id. at 377.

<sup>134</sup> Id.

<sup>135</sup> Kahan, supra note 4, at 353.

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ambiguity, <sup>136</sup> Nash's reasoning strongly suggests that the Sherman Act's Rule of Reason is not ambiguous in a lenity-triggering sense; that is, the mere fact that its application cannot be precisely predicted in advance does not, as a formal matter, leave the statute's meaning ambiguous. 137 This conclusion is further supported by the Supreme Court's reasons for reading Sherman Act Section 2, like Section 1, also to require "resort" to "the rule of reason." The Court conceded potential "ambiguity" in "determining what is intended by monopolize."139 But the Court explained: "this ambiguity is readily dispelled' by "indication[s]" from the "history of the law of restraint of trade" of Congress's intent that Section 2 complement Section 1; accordingly, when the two provisions are "harmonized," it is "obvious that the criteria to be resorted to in any given [Section 2] case [is] the rule of reason guided by the established law and by the plain duty to enforce the prohibitions of the act, and thus the public policy which its restrictions were obviously enacted to subserve."140 Even if Section 2's application is indeterminate, its ultimate substantive touchtone, the Court held, is unambiguous. 141

<sup>&</sup>lt;sup>136</sup> See Marx, supra note 64, at 246 ("In short, while due process notice requires a certain degree of clarity in criminal statutes, it does not require the degree required to satisfy lenity.").

<sup>&</sup>lt;sup>137</sup> Indeed, some cite *Nash* as illustrating the Rule of Lenity's inapplicability to the Sherman Act. *See* Elhauge, *supra* note 111, at 2201.

<sup>138</sup> Standard Oil v. United States, 221 U.S. 1, 61-62 (1911).

<sup>139</sup> Id. at 61.

<sup>&</sup>lt;sup>140</sup> *Id.* at 61-62 (emphasis added).

Notably, Nash, too, noted that the Rule of Reason governed Section 2 as well as Section 1, and Nash itself involved a conspiracy-to-monopolize claim. This is potentially significant for resolution of what some term the "exclusionary conduct definition war." Popofsky, supra note 10, at 435 (internal quotations omitted). If applying the Rule of Reason to Section 2 avoids a vagueness challenge, then that suggests that the Microsoft court rightly read Section 2 to implement the Rule of Reason. See Microsoft, 253 F.3d at 59. The Rule of Reason's applicability to

Distinguishing clear statutory meaning – apparently sufficient to avoid lenity-triggering ambiguity - from indeterminate application remains a formal argument for the Rule of Lenity's inapplicability to the Sherman Act. 142 The less precise the purportedly unambiguous statute (and the Rule of Reason is an imprecise standard), the wider judicial latitude to "make" law through implicit congressional delegation, 143 and the greater the degree a statute's practical ambiguity. This is particularly true with respect to Section 2, where not only the statute's application, but also the operative legal test, remain unclear for many categories of conduct. Moreover, the Supreme Court has not yet directly confronted whether the Rule of Lenity applies to the Sherman Act, and *Illinois Tool Works* could be read to imply that the Court does not view the matter as fully settled against lenity. Thus, a complete answer to why the Rule of Lenity ought to play no meaningful role in shaping Section 2 must lie elsewhere, including in an examination of whether applying the Rule of Lenity to the Sherman Act would advance the canon's underlying purposes.

# B. The Functional Answer: The Reasons for Resorting to Lenity are Inapplicable to Section 2

Section 2, however, does not preclude more particular rules that govern discrete categories of conduct. *See* Popofsky, *supra* note 10, at 441-56.

<sup>142</sup> It nonetheless might prove adequate. The Supreme Court has found sufficient clarity in numerous other broadly-worded statutes (such as mail fraud and RICO) to avoid a conclusion of lenity-triggering ambiguity. See generally Kahan, supra note 4, at 378-81.

<sup>&</sup>lt;sup>143</sup> As Justice Stevens explained: "Statutes like the Sherman Act... were written in broad general language on the understanding that the courts would have wide latitude in construing them to achieve the remedial purposes that Congress had identified. The wide open spaces in statutes such as these are most appropriately interpreted as implicit delegations of authority to the courts to fill in the gaps in the common-law tradition of case-by-case adjudication." McNally v. United States, 483 U.S. 350, 372-73 (1987) (Stevens, J., dissenting).

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Examination of the Rule of Lenity's asserted purposes reveals a poor fit with the Sherman Act. Accordingly, a court confronted with the argument that the Rule of Lenity ought to help inform the content of Section 2's Rule of Reason should reject the contention not only because the Rule of Reason lacks ambiguity in the lenity-triggering sense, but also because embracing the argument would not legitimately advance the values that the canon assertedly protects.

### 1. The Rule of Lenity's Problematic Rationales

Although the Rule of Lenity "is perhaps not much less old than construction itself," <sup>144</sup> great disagreement persists as to the underlying purpose it serves. <sup>145</sup> Some contend that lenity reinforces the same "fair notice" values that underlie the void for vagueness doctrine. <sup>146</sup> This rationale, as many observe, is essentially a legal fiction and cannot withstand "critical examination." <sup>147</sup> For one thing, "criminals do not read statutes." <sup>148</sup> For another, interpretive tools that can preclude a conclusion of statutory ambiguity (judicial gloss and the polices behind the law, to name a few) "hardly provide notice 'in language that the common world will understand" <sup>149</sup> of what the law condemns. The Rule of Lenity, in other words, "substantially underprotects the

<sup>144</sup> Kahan, supra note 4, at 358 (citing Wiltberger).

<sup>&</sup>lt;sup>145</sup> See generally id. at 389-96; Price, supra note 124, at 907-12.

<sup>146</sup> For an articulation of this view, see generally Lawrence M. Solan, Law, Language, and Lenity, 40 WM. & MARY L. REV. 57, 134-41 (1998). Justice Holmes' famous opinion in McBoyle v. United States, 283 U.S. 25 (1931), often is cited as emblematic of the notice rationale for lenity.

<sup>&</sup>lt;sup>147</sup> Price, *supra* note 124, at 907; Marx, *supra* note 64, at 243.

<sup>&</sup>lt;sup>148</sup> Price, *supra* note 124, at 886.

<sup>&</sup>lt;sup>149</sup> United States v. Bass, 404 U.S. 336, 348 (1976) (quoting McBoyle v. United States, 283 U.S. 25, 27 (1931)).

interest in fair notice."150

Lenity, it is argued, reinforces legislative supremacy and its corollary that only the legislature, and not courts, can create crimes. 151 This rationale for the Rule of Lenity, however, cannot be squared with the reality of judicial elaboration of innumerable federal statutes that contain language that is not self-executing. 152 Moreover, as one commentator noted, "[t]here is no reason to suppose legislatures would not sometimes prefer" to "pass ] off the details of criminal lawmaking to the courts." 153 Put more generally, promoting legislative supremacy cannot explain the doctrine as a descriptive matter, because the doctrine has not served to protect against the de facto creation of common law crimes through judicial elaboration of statutes and because "state legislatures almost universally have attempted to abrogate lenity by statutory rules of construction." 154 Nor can legislative supremacy justify the doctrine normatively in light of the practical inability of legislatures to specify every application of statutes in advance and the doctrine's inapplicability to the construction of solely civil statutes. 155

Some also suggest that the Rule of Lenity promotes the rule of law by reducing prosecutorial discretion and ensuring legislative

<sup>&</sup>lt;sup>150</sup> Note, *supra* note 112, at 2425.

<sup>151</sup> See generally id. at 2425-26 (describing the separation of powers rationale for lenity); Marx, supra note 64, at 244 (same). Indeed, the U.S. Supreme Court's first employment of the Rule of Lenity rested on this rationale. "The rule that penal laws are to be construed strictly," Chief Justice Marshall wrote, "is founded . . . on the plain principle that the power of punishment is vested in the legislative, not in the judicial department." Wiltberger v. United States, 18 U.S. (5 Wheat) 76, 95 (1820).

<sup>&</sup>lt;sup>152</sup> See generally Note, supra note 112, at 2425-26; Price, supra note 124 at 909-10.

<sup>153</sup> Price, supra note 124, at 909-10; Marx, supra note 64, at 244.

<sup>&</sup>lt;sup>154</sup> Marx, *supra* note 64, at 244.

<sup>&</sup>lt;sup>155</sup> See Price, supra note 124, at 909-10.

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accountability.<sup>156</sup> Strict construction of criminal statutes, it is argued, ensures that legislatures do not criminalize conduct without the voters knowing it.<sup>157</sup> A strong application of the Rule of Lenity, the argument further runs, ensures that prosecutors do not abuse their discretion in charging decisions.<sup>158</sup> But as one commentator has observed, "[t]he rule of law justification for lenity fails because it confuses ambiguity with [over]breadth."<sup>159</sup> Congress can pass "broad yet clear" statutes, the breadth of which may escape notice of the voters yet create opportunities for selective prosecution.<sup>160</sup> Moreover, "a strong rule of lenity could even 'cause more overcriminalization than it prevents' by giving legislators incentives to pass even broader statutes."<sup>161</sup>

To the above three traditional justifications for the Rule of Lenity – none of which strongly support the canon – can be added another, which is actually a variation on the fair notice theme: lenity avoids criminalizing conduct that is not plainly wrongful absent a clear statement from Congress. Criminal statutes often are characterized either as malum in se, which condemn conduct that is facially wrongful, or malum prohibita, which condemn conduct that is not. Malum in se conduct, the argument runs, "provide[s]s notice of

<sup>156</sup> See id. at 911-12. Professor Elhauge has explained the Rule of Lenity in similar, "preference-eliciting" terms: "By providing the most lenient reading in unclear cases, the rule of lenity forces legislatures to define just how anti-criminal they wish to be, and how far to go with the interest in punishing crime when it runs up against other societal interests." EINER ELHAUGE, STATUTORY DEFAULT RULES: HOW TO INTERPRET UNCLEAR LEGISLATION 169 (2008).

<sup>&</sup>lt;sup>157</sup> See Price, supra note 124, at 911, 916 (explaining that lenity "compels [legislatures] to own up" to the precise conduct criminalized).

<sup>&</sup>lt;sup>158</sup> See id. at 918-21.

<sup>&</sup>lt;sup>159</sup> Note, *supra* note 112, at 2427.

<sup>160</sup> Id

<sup>161</sup> Id. (quoting William J. Stuntz, The Pathological Politics of Criminal Law, 100 MICH. L. REV. 505, 561 (2001)).

wrongfulness by [its] very nature."<sup>162</sup> By contrast, "[w]hen the conduct at issue is only *malum prohibitum*, however, this notice can only be guaranteed if the statute incorporates knowledge of illegality" or of "wrongfulness."<sup>163</sup> Viewed in this light, the Rule of Lenity ensures that Congress clearly specifies when it intends to condemn *malum in prohibita* conduct by resolving ambiguities in the defendant's favor. <sup>164</sup>

This rationale, too, only imperfectly fits with the Rule of Lenity. As one scholar observes, "the rule of lenity['s rationale] is strongest in mala prohibita cases and weakest in malum in se cases" but "the actual doctrine does not draw this distinction" and the pattern of application is precisely the reverse. The rule of lenity is applied more consistently in malum in se offense than mala prohibita ones." <sup>165</sup> Nevertheless, deployment of the canon to ensure that the legislature in fact criminalized wrongful conduct explains a number of recent cases, <sup>166</sup> including the generative Thompson/Center Arms decision. <sup>167</sup> Moreover, the rationale supplies a more satisfying reason for invoking the canon than the more general fair notice argument, which is recognized to rest on a legal fiction.

<sup>&</sup>lt;sup>162</sup> Id. at 2435.

<sup>163</sup> Id.

A closely-related rationale for lenity is that the doctrine reduces the costs of interpretive errors by "[s]kewing statutory construction toward under-rather than over-criminalization." Marx, supra note 64, at 245.

Elhauge, supra note 111, at 2201; see also Price, supra note 124, at 909 ("If the notice theory is insufficient to justify the application of lenity across the gamut of crimes, there appears to be little authority to support selective application of the rule to some crimes but not others.").

<sup>&</sup>lt;sup>166</sup> See Note, supra note 112, at 2434-36.

<sup>167</sup> See Marx, supra note 64, at 258-60 (observing that Thompson/Center Arms invoke lenity in part because the statute lacked a mens rea requirement and suggesting that a "narrow" reading of that decision "suggests that lenity applies to hybrid statutes in civil cases only when the criminal prohibition contains no additional mens rea requirement").

# 2. The Even More Problematic Fit Between Lenity's Rationales and Section 2

None of these relatively weak rationales for the Rule of Lenity strongly support, let alone compel, a doctrine that "doubts" go to a Section 2 defendant. Section 2's incorporation of the Rule of Reason defeats notice, separation of powers, and legislative accountability justifications for the canon's application. The Rule of Reason does not leave Section 2 so bereft of meaning that one can "make no more than a guess as to what Congress intended."168 Congress intended the federal courts to make case-specific judgments concerning the reasonableness of conduct, and to develop that doctrine in a commonlaw fashion. 169 To be sure, that Section 2 invokes the dynamic content of reasonableness means that Section 2's reach is not static and its application to particular conduct is sometimes uncertain. But that would be true even if courts applied the Rule of Lenity to Section 2; uncertainty would simply exist over a potentially narrower subset of fact patterns. Moreover, Nash teaches that some level of uncertainty as to conduct's reasonableness is not at war with fair notice. 170

<sup>&</sup>lt;sup>168</sup> United States v. Wells, 519 U.S. 482, 499 (1997) (internal quotations omitted); see also Burgess v. United States, 128 S. Ct. 1572, 1580 (2008) (observing that the Rule of Lenity "applies only when, after consulting traditional canons of statutory construction, we are left with an ambiguous statute" (internal quotations omitted)).

See, e.g., Leegin, 127 S. Ct. at 2724 ("Congress intended § 1 to give courts the ability to develop governing principles of law in the common-law tradition." (internal quotations omitted)). For the same reason, applying the Rule of Lenity to the Sherman Act would not advance "democratic accountability"; that is, "compel[ling] lawmakers" to "indicate explicitly what they are doing." Price, supra note 124, at 887-88. Although the Rule of Reason's application cannot be completely specified in advance, the public understands that Congress charged the federal courts to elaborate the rules of the competitive road in the common-law tradition.

<sup>&</sup>lt;sup>170</sup> Nash v. United States, 299 U.S. 373, 376-77 (1913).

Nor would applying the Rule of Lenity to narrow Section 2 legitimately further legislative supremacy. If, as Nash held, the Sherman Act's enshrinement of the reasonableness principle does not itself amount to an unconstitutional delegation of the power to create common-law crimes, the Rule of Lenity ought not protect that unviolated constitutional value by requiring narrowing constructions. Some might argue that judicial elaboration of reasonableness effectively is an impermissible delegation of legislative power. But if such judicial elaboration is not constitutionally impermissible – and no such argument has successfully been advanced in the case of the Sherman Act – the Rule of Lenity is not properly deployed in service of an inapplicable non-delegation principle.<sup>171</sup> Nor would a lenity-based Rule that Section 2 doubts go to the defendant advance such a principle. Whether Section 2's Rule of Reason is read "broadly" or "narrowly" would not affect the legitimacy of Congress's "delegation" of criminal law-making authority.

As for lenity's role in upholding the rule of law by constraining prosecutorial discretion: the reality is that for at least thirty years Section 2 has not been enforced criminally; the only realistic threat of Section 2 criminal enforcement today involves circumstances that also would comprise *per se* violations of Section 1. Over-criminalization of conduct subject to Section 2 is not a realistic concern. Accordingly, that rationale for lenity provides no warrant for narrowing a statute that is exclusively enforced, and almost surely will be exclusively forced, through actions for injunctive relief and civil damages.

On the contrary, a lenity-based narrowing of Section 2 merely would undesirably exacerbate American civil antitrust schizophrenia.

<sup>&</sup>lt;sup>171</sup> See Elhauge, supra note 156, at 178 (arguing that "congress has every right" to "delegat[e] to the federal courts the power to devise and revise [antitrust] rules of conduct in common law fashion"); cf. Marx, supra note 64, at 245-46 ("It should be emphasized that lenity is a rule of statutory construction, not a means of smuggling constitutional law in through the back door to save an otherwise unambiguously constitutional statute or to avoid a difficult constitutional question.").

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Certain antitrust statutes – Section 5 of the FTC Act<sup>172</sup> and Sections 3<sup>173</sup> and 7<sup>174</sup> of the Clayton Act – proscribe conduct that also can be reached by Sherman Act Section 2<sup>175</sup>; yet those provisions do not define crimes. The Case is much weaker, if it can be made at all, for employing lenity to narrow these provisions. The Employing lenity to limit Section 2 also would shine an even more intense spotlight on whether, and to what extent, the FTC Act can reach conduct beyond that condemned by the Sherman Act, The and potentially aggravate the perceived unfairness of the substantive antitrust standard turning on the happenstance of the FTC taking up a matter. Antitrust plaintiffs, moreover, can be expected to seek to shoe horn what really are square peg Section 2 cases into the round holes of the Clayton Act. None of this advances the sound development of antitrust law.

That leaves the argument that resolving Section 2 doubts in the

<sup>&</sup>lt;sup>172</sup> 15 U.S.C. § 45.

<sup>173 15</sup> U.S.C. § 14.

<sup>174 15</sup> U.S.C. § 18.

These statutes, however, also reach other conduct. For example, Section 7 of the Clayton Act can condemn mergers that do not threaten to create monopoly power.

Notably, certain provisions of other "antitrust" statutes, including the Robinson-Patman and Wilson Tariff Acts, do carry criminal penalties. *See* 15 U.S.C. §§ 8, 13a.

<sup>&</sup>lt;sup>177</sup> The argument would be that construction of these provisions must be consistent with the antitrust laws as a whole.

<sup>178</sup> The FTC has recently sought to enforce Section 5 even when the conduct would not amount to a Sherman Act violation. See In re Negotiated Data Solutions, LLC, No. 051-0094 (2007), available at www.ftc.gov/os/caselist/0510094/index. shtm.

For example, litigants might seek to link "monopolizing" conduct to prior acquisitions challenged under Clayton Act Section 7, see Reading Int'l Inc. v. Oaktree Cap. Mgmt. LLC, 317 F. Supp. 2d 301, 311-17 (S.D.N.Y. 2003), or stress conditions on dealings reached by Clayton Act Section 3.

defendant's favor provides assurances that defendants know they have committed wrongful conduct. Beyond the point that actual criminal enforcement of Section 2 is merely notional, the *mens rea* requirement for Section 2 convictions required by the Supreme Court in *United States v. United States Gypsum Co.*<sup>180</sup> sufficiently fulfills that role. There is no need to confine Section 2's substantive reach to avoid criminalizing a mere error in judgment.

Both the Supreme Court's rationale for reading the Sherman Act to impose a mens rea requirement for a criminal offense beyond that required for a civil violation, and the content of the Sherman Act's criminal intent element, reinforce this conclusion. Gypsum read the Sherman Act to require a certain level of intent – and although the case concerned Section 1, Gypsum's mens rea requirement plainly is applicable also to Section 2<sup>181</sup> – for a number of reasons. First, "with regard to crimes having their origin in the common law," the Court's cases established "an interpretative presumption" that "mens rea is required." This presumption rests, the Court observed, on the assumption that "Congress will be presumed to have legislated against the background of our traditional legal concepts which render intent a critical factor." Is Importantly, the Court reasoned that those "traditional legal concepts" themselves derive from the same source as

<sup>180 438</sup> U.S. 422 (1978).

<sup>181</sup> Gyspum did not distinguish between Section 1 and Section 2; on the contrary, the Court noted that both Section 1 and Section 2 are criminal statutes and cited Standard Oil Co. v. United States, 221 U.S. 1 (1911), which recognized that both Sections 1 and 2 invoke the rule of reason. See Gypsum, 438 U.S. at 438. Antitrust Division guidelines cited by the Court, moreover, expressly contemplated criminal Section 2 offenses and listed "other violations of the Sherman Act where there is proof of a specific intent to restrain trade or to monopolize" as among the "type" of "offenses" that "are prosecuted criminally." Id. at 440.

<sup>&</sup>lt;sup>182</sup> Gypsum, 438 U.S. at 437.

<sup>183</sup> Id.

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the Rule of Lenity: to "read a state-of-mind component into an offense even when the statutory definition did not in terms so provide," according to the Court, was "*in keeping* with the common-law tradition and with the general injunction that 'ambiguity concerning the ambit of criminal statutes should be resolved in favor on lenity." <sup>184</sup>

The Court's second reason for reading the criminal Sherman Act offense to require mens rea - the Act's potential substantive breadth and common law elaboration – even more directly answers lenity based concern with condemning a mere error in judgment. "The Sherman Act," the Court observed, "unlike most traditional criminal statutes, does not, in clear and categorical terms, precisely identify the conduct which it proscribes."185 "Nor has judicial elaboration of the Act always yielded clear and definitive rules of conduct which the statute omits; instead open-ended and fact-specific standards like the 'rule of reason' have been applied to broad classes of conduct falling within the purview of the Act's general provisions."186 The Sherman Act, in other words, exhibits "indeterminancy." 187 The inability precisely to predict criminal liability supported requiring some level of intent beyond intent to engage in the conduct. As the Court put it, the "same basic concerns which are manifested in our general requirement of mens rea in criminal statutes" are "at least equally salient in the antitrust context."188

Importantly, the Court found this concern "buttressed" by

<sup>184</sup> Id. (emphasis added) (quoting Rewis v. United States, 401 U.S. 808, 812 (1971)). As some scholars have observed, the common-law Rule of Lenity differed significantly from that first invoked by the Supreme Court in Wiltberger. See generally Kahan, supra note 4, at 357-61. Nonetheless, the important point for present purposes is that Gypsum associated the underlying concerns that animate the mens rea presumption with lenity.

<sup>&</sup>lt;sup>185</sup> *Gypsum*, 438 U.S. at 438.

<sup>186</sup> Id. at 438 (citations omitted).

<sup>187</sup> Id. at 439.

<sup>188</sup> Id. at 440.

"[c]lose attention to the type of conduct regulated by the Sherman Act." Outside of conduct condemned as *per se* unlawful, "the behavior prescribed by the Act is often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct." The imposition of criminal liability . . . for engaging in such conduct which only after the fact is determined to violate the statute because of anticompetitive effects, without inquiring into the intent with which it was undertaken," the Court reasoned, "holds out the distinct possibility of overdeterrence." 191

Gypsum's invocation of the Sherman Act's indeterminacy, the Court's recognition of the Act's potential otherwise to condemn conduct which "is often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct," and the Court's conclusion that a mens rea requirement diminishes the prospect that "salutary and procompetitive conduct lying close to the borderline of impermissible conduct might be shunned by businessmen who chose to be excessively cautious in the face of uncertainty regarding possible exposure to criminal punishment for even a goodfaith error in judgment," 192 all reinforce the absence of any justification for invoking lenity to confine Section 2's substantive scope. For one thing, if the very substantive breadth of the Sherman Act is a reason to require a mens rea requirement that is "in keeping" with the Rule of Lenity, lenity can hardly be invoked to reduce the statute's substantive scope. Put differently, Gypsum's mens rea requirement presupposes

<sup>189</sup> Id.

requirement included the severity of criminal sanctions, see id. at 442 n.18, recognition in the Sherman Act's legislative history of the traditional distinctions between civil and criminal offenses, id. at 443 n.19, and reluctance to impute to Congress an intent to wield criminal sanctions to regulate rather than "punish conscious and calculated wrongdoing," id. at 442.

<sup>&</sup>lt;sup>191</sup> *Id.* at 441.

<sup>192</sup> Id.

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that the Sherman Act exhibits a "generality and adaptability comparable to that found to be desirable in constitutional provisions." Invoking lenity to narrow the Sherman Act is thus inconsistent with the scope of the Sherman Act *Gypsum* assumed, a scope which reinforced the Court's conclusion that a criminal Sherman Act offense requires some level of intent.

For another, if, as the Court reasoned, a *mens rea* requirement diminishes overdeterrence by precluding criminalization of unintended anticompetitive conduct, that undermines the need to invoke lenity to ensure that a defendant has knowledge of wrongdoing for *malum in prohibita* criminal offenses. The *mens rea* requirement ensures notice of wrongfulness. *Gypsum*'s description of the *mens rea* required for a criminal Rule of Reason conviction illustrates the point. Although *Gypsum* did not require proof of the antitrust defendant's "conscious object" to cause anticompetitive effects, <sup>194</sup> the Court did require proof of "action undertaken with knowledge of its probable [anticompetitive] consequences." Requiring knowledge that "proscribed effects would most likely follow" is the antitrust equivalent of requiring awareness of conduct's wrongfulness. <sup>196</sup>

Although lower courts have read *Gypsum* to permit less demanding proof of intent to demonstrate a *per se* criminal violation of the Sherman Act, <sup>197</sup> *Gypsum*'s requirement that the government prove

<sup>193</sup> *Id.* at 439 (internal quotation omitted).

<sup>194</sup> Id. at 444.

<sup>&</sup>lt;sup>195</sup> *Id.* The Court further explained that evidence of "conscious object" intent could support criminal liability if anticompetitive effects otherwise also required for liability "did not come to pass." *Id.* n.21.

<sup>196</sup> Id.

<sup>197</sup> Courts reason that "[w]here per se conduct is found, a finding of intent to conspire to commit the offense is sufficient; a requirement that intent go further and envision actual anti-competitive results would reopen the very questions of reasonableness which the per se rule is designed to avoid." United States v. Koppers Co., 652 F.2d 290, 296 n.6 (2d Cir. 1981). See also, e.g., United States v.

knowledge of probable anticompetitive effects in a criminal Rule of Reason prosecution cuts decisively against invoking lenity to confine Section 2. *Gyspum*'s knowledge requirement is plainly more demanding than the intent required for a civil violation of Section 2's monopolization proscription, which is merely that the antitrust defendant knowingly engaged in the conduct that gives rise to the violation. And *Gypsum*'s knowledge requirement arguably provides the very notice of wrongdoing that some commentators contend is a central reason for invoking lenity.

Gypsum leaves one apparent puzzle. In requiring knowledge of probable anticompetitive effects for a Sherman Act criminal violation, Gyspum created a distinction in the elements required for a civil and criminal Sherman Act violation for the very same conduct under the very same statutory provision (whether Section 1 or Section 2). It might be argued, therefore, that Gypsum renders the "textual identity" and "least common denominator" principles inapplicable to the Sherman Act. As the Supreme Court's invocation of lenity in the civil Illinois Tool Works case suggests, such a conclusion is likely incorrect.

Brown, 936 F.2d 1042, 1046 (9th Cir. 1991) (following Koppers and explaining that its rule "accords with the express holdings of six other circuits, and the intimations of another"); United States v. Cargo Serv. Stations, Inc., 657 F.2d 676, 682-84 (5th Cir. 1981); United States v. Brighton Bldg. & Maint. Co., 598 F.2d 1101, 1106 (7th Cir. 1979); United States v. Cont'l Group, Inc., 603 F.2d 444, 461-62 (3d Cir. 1979).

198 See United States v. Griffith, 334 U.S. 100, 107 (1948); see also Aspen Skiing Co. v. Aspen Highland Skiing Corp., 472 U.S. 585, 602 & n.28 (1985) (explaining that "no monopolist monopolizes unconscious of what he is doing" (quoting Alcoa, 148 F.2d 416, 432 (2d Cir. 1945))). The conspiracy to monopolize and attempt to monopolize offenses are judicially construed to require specific intent to monopolize, even in a civil setting. See, e.g., Spectrum Sports, Inc. v. McQuillan, 506 U.S. 447, 456 (1993). However, "specific intent to monopolize" can be inferred from engaging in conduct that causes anticompetitive effects, id. at 459; thus, as a practical matter, specific intent to monopolize appears to be less demanding than Gyspum's mens rea requirement for a criminal Rule of Reason violation.

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Instead, as the United States has argued, the *mens rea* presumption *Gypsum* invoked can be reconciled with the textual identity principle by conceptualizing the Sherman Act to have "an implied clause stating that, in its criminal applications, *mens rea* must be shown" that does not affect the construction of the statute's express provisions. <sup>199</sup>

The mens rea requirement for the Sherman Act's criminal applications, in other words, arises from a special background presumption against which Congress is assumed to legislate that is inapplicable to construing the express statutory language. This method of easing the tension between the criminal mens rea requirement and the textual identity principle is suggested by Gyspum itself, which noted that "[b]oth civil remedies and criminal sanctions are authorized with regard to the same generalized definitions of the conduct proscribed – restraints of trade or commerce and illegal monopolization – without reference to or mention of intent or state of mind." 201

### 3. Lenity is Unnecessary to Calibrate Section 2 Legal Tests

Finally, against the extremely poor fit between the rationales for employing lenity to inform the elaboration of Section 2 stands perhaps a stronger counter-force: The Sherman Act, including Section 2, forms

See, e.g., Brief for the United States at 11, United States v. Nippon Paper Indus. Co., No. 96-2001 (1st Cir. filed Nov. 25, 1996), available at http://www.justice.gov/atr/cases/f1000/1002.htm.

<sup>&</sup>lt;sup>200</sup> Cf. Marx, supra note 64, at 276-77 ("Under a presumption of consistent usage, terms of art common to civil and criminal portions of hybrid statutes should be interpreted as having the same meaning. The presence of mens rea terms in the criminal portion of the statute does not affect the probative value of the legislative decision to use the term of art in both contexts. . . . The common term should have the same application in both civil and criminal cases, even though the civil and criminal portions of the statute are different in an important respect: the presence of mens rea.").

<sup>&</sup>lt;sup>201</sup> Gypsum, 438 U.S. at 438.

part of a "charter of freedom." <sup>202</sup> It is part of "the Magna Carta of free enterprise," as "important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms." <sup>203</sup> Particularly in light of the merely theoretical possibility of criminal enforcement, there is no place in a statute recognized to have the "generality and adaptability comparable to that found to be desirable in constitutional provisions" <sup>204</sup> for a background assumption in favor of narrow constructions. <sup>205</sup>

To be sure, the Sherman Act's "charter of freedom" does not proscribe all private restraints; nor does the Act create a guarantee of the right to compete on particular terms with dominant firms. The Sherman Act's Rule of Reason (used here in the sense of a principle by which courts construe the Sherman Act<sup>206</sup>) contemplates judicial elaboration of administrable rules of the competitive road that are calculated to make consumers in the long run better off relative to the application of other rules. Concerns with over-deterrence, the relative balance of false-positives and false-negatives, and the costs and benefits of more general standards as compared to more precise rules properly inform Section 2's elaboration. As the Court in *Gypsum* recognized, antitrust differs from other areas of the law, because

<sup>&</sup>lt;sup>202</sup> Appalachian Coals, Inc. v. United States, 288 U.S. 344, 359 (1933).

<sup>&</sup>lt;sup>203</sup> United States v. Topco Assocs., Inc., 405 U.S. 596, 610 (1972).

<sup>&</sup>lt;sup>204</sup> Gypsum, 438 U.S. at 439 (internal quotations omitted).

<sup>205</sup> Cf. Marx, supra note 64, at 275 ("Presumptions of lenity or broad construction should not be decisive of ambiguities in hybrid statutes, unless the court makes a determination that the statute is hybrid in name only that is, its enforcement and application are so overwhelmingly civil or criminal that permitting purely civil or purely criminal rules of construction to govern will be appropriate." (emphasis added)). The tension with other provisions of the antitrust laws that applying lenity to Section 2 would exacerbate, discussed above, reinforces this point.

<sup>&</sup>lt;sup>206</sup> See Popofsky, supra note 10, at 453-56.

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"excessive caution" generated by inappropriate legal tests "will not necessarily redound to the public's benefit." 207

It is precisely the ability of Section 2 courts applying antirust principles in a common law fashion directly to take into account overdeterrence concerns liability tests create that leaves no proper role for lenity. A lenity-based view of Section 2, as explained, suggests a strong *presumption* that benefits from judicial intervention are not worth the costs.<sup>208</sup> But the common-law process by which Section 2 doctrines are generated, as Trinko<sup>209</sup> illustrates, allows courts to perform that cost/benefit analysis for particular conduct. There is, accordingly, no reason for a special lenity-based "ethical prescription"210 that confines Section 2's scope. Put differently, the debate over Section 2's meaning should be informed by predictive judgments concerning the relative costs and benefits to competition and consumers of applying a given test to assess the legality of particular conduct as opposed to some other legal test. Lenity does not provide a valid basis for putting a thumb on the scale in that judicial weighing.

Illinois Tool Works is not to the contrary. The Court first invoked the criminal nature of the Sherman Act in contrasting International Salt's special per se rule for patent tying (presuming market power) to Congress's 1988 amendment to the Patent Act respecting the showing required for tying to amount to misuse (requiring a demonstration of market power). The Court reasoned: "It would be absurd to assume that Congress intended to provide that the use of a patent that merited punishment as a felony would not constitute misuse." This statement does not compel a lenity-based

<sup>&</sup>lt;sup>207</sup> Gypsum, 438 U.S. at 441 n.17.

<sup>208</sup> See supra notes 99-107.

<sup>&</sup>lt;sup>209</sup> Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, 540 U.S. 398 (2004).

<sup>&</sup>lt;sup>210</sup> Taranto, supra note 2, at 180.

<sup>211</sup> Illinois Tool Works, 547 U.S. at 42.

rule of strict construction. Instead, it recognizes the textual identity principle (how the Sherman Act is construed civilly equally applies when enforced criminally) and acknowledges that the elaboration of the common law (and therefore of the Sherman Act) properly takes into account "statutory policy laid down by the legislature in closely related areas."

Nor is the Court's direct reference to lenity a command to apply it. The Court noted that the U.S. antitrust enforcers in "their prosecutorial discretion" refused to presume market power from patents.<sup>213</sup> "While that choice is not binding on the Court," Justice Stevens continued, "it would be unusual for the Judiciary to replace the normal rule of lenity that is applied in criminal cases with a rule of severity for a special category of antitrust cases."214 The Court, here, simply made the observation that *International Salt's per se* rule runs far outside the currents of modern antitrust. In particular, the Court cited the "normal rule of lenity applied in criminal cases" to illustrate the effect of maintaining International Salt's market power presumption: such a ruling would perpetuate an unsound special "rule of severity" - the opposite, the Court implied, of the "normal" Rule of Lenity. It is one thing to contrast a special "rule of severity" with the Rule of Lenity, a contrast that reaffirms the application of textual identity principle to the Sherman Act. It is quite another, and inappropriate, to read that invocation as a holding that the Rule of Lenity requires strict constructions of the Sherman Act, an argument no brief submitted in *Illinois Tool Works* made. 215

<sup>&</sup>lt;sup>212</sup> Taranto, *supra* note 2, at 177 (citing Moragne v. State Marine Lines, 398 U.S. 375, 390-91 (1970)).

<sup>213</sup> Illinois Tool Works, 547 U.S. at 45.

<sup>&</sup>lt;sup>214</sup> *Id*.

None of the merits briefs filed in *Illinois Tools Works* so much as mentioned the Rule of Lenity.

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### CONCLUSION

The Supreme Court's invocation of the criminal nature of the Sherman Act in *Illinois Tool Works* is indeed "striking."<sup>216</sup> But as with many Supreme Court *dicta*, it intrigues more than it illuminates.<sup>217</sup> Examination of the Rule of Lenity's operation and its underlying rationale demonstrate that the canon fits poorly with, and accordingly ought not to inform, Section 2 of the Sherman Act. Courts confronted with the argument that Section 2 liability is improper because strict construction is required by the criminal nature of the statute should reject the contention. The mysteries of Section 2 of Sherman Act may not present easy answers. That the Sherman Act defines a crime, however, does not provide an easy out.

<sup>&</sup>lt;sup>216</sup> Taranto, supra note 2, at 178.

<sup>&</sup>lt;sup>217</sup> As Guildenstern quipped: "What a fine persecution – to be kept intrigued without ever quite being enlightened." THOMAS STOPPARD, ROSENCRANTZ AND GUILDENSTERN ARE DEAD 41 (Grove Press 1967).

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### W. EDWARD AFIELD

# Dining with Tax Collectors: Reducing the Tax Gap Through Church-Government Partnerships

ABSTRACT. This article explores an untapped resource in improving tax compliance: partnerships between the government and Judeo Christian religious organizations. Currently, most of the techniques the IRS employs to improve tax compliance are based on a traditional theory of law enforcement in which compliance is achieved through a combination of increasing the probability of detection and/or increasing the potential penalty. Although the IRS has begun to adopt some initiatives based on awareness that factors apart from a simple economic calculus motivate tax compliance decisions, these programs are still in their infancy. The solutions that the IRS is considering are worthwhile, but they are mere stopgaps. In order to achieve a more lasting improvement in compliance rates, the IRS must considerably expand its efforts beyond the traditional theories of enforcement and adopt strategies that help establish tax compliance as an underlying social virtue. Scholars have recognized this need, but the current literature has paid little attention to how religious organizations can be used to help effect this change in taxpayer attitudes. Partnerships between the government and religious organizations have significant potential to effect a culture change by providing more effective forums for taxpayer education than those currently used and by serving as intermediaries between taxpayers and the government. These partnerships, if implemented correctly (as they have been in other areas of law enforcement), potentially could help create a longterm norm shift that would improve compliance, without significantly burdening the IRS' already underwhelming resources.

AUTHOR. Assistant Professor of Law, Ave Maria School of Law. I would like to thank Mark Cochran, the participants in the Florida Legal Scholarship Forum held at Stetson University College of Law, and the participants in faculty workshops held at Atlanta's John Marshall Law School and Ave Maria School of Law for their valuable comments on this piece. In addition, I am grateful for the research assistance of Kristin Ambrozic, Nicole DeAnda, Rebecca Haynes, and Katherine Hermann. All errors are my responsibility alone.

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### INTRODUCTION

While he was at table in his house, many tax collectors and sinners came and sat with Jesus and his disciples. The Pharisees saw this and said to his disciples, "Why does your teacher eat with tax collectors and sinners?" He heard this and said, "Those who are well do not need a physician, but the sick do."

Matthew 9:10-121

In the introductory quotation, Jesus is questioned for his decision to dine with tax collectors, who were widely regarded to be sinners for their extortive collection practices.<sup>2</sup> Jesus' response provides an early example of religion influencing tax enforcement to remedy a damaging culture. The Biblical passage was concerned with the unjust practices of the tax collectors themselves. Today, the moral conversation on tax compliance has shifted its focus to the unjust practices of the taxpayers themselves, which have combined to produce a significant revenue shortfall known as the "tax gap."

The "tax gap" is simply the difference between the amount of revenue that should be collected under the tax system in a given year and the amount that is actually collected.<sup>3</sup> The best estimate for the size of the gross tax gap is \$345 billion per year.<sup>4</sup> This translates to a voluntary compliance rate of 83.7%.<sup>5</sup>

THE CATHOLIC STUDY BIBLE (NEW AMERICAN BIBLE) (Donald Senior, ed., Oxford University Press 1990).

<sup>&</sup>lt;sup>2</sup> See id. for an annotation discussing Mark 2:14.

For a more detailed discussion of the definition of the tax gap, see Reducing the Federal Tax Gap: a Report on Improving Voluntary Compliance, U.S. Department of the Treasury, Internal Revenue Service, August 2, 2007, 6.

See Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance, U.S. Department of the Treasury, Office of Tax Policy, July 8, 2009,

Faced with limited resources, the IRS has had to use its available tools as efficiently as possible in combating the tax gap.<sup>6</sup> The IRS is currently considering a variety of proposals to improve the compliance rate, including: (1) increased information reporting; (2) strengthened tax administration; (3) expansion of certain penalties; (4) combating underreporting of offshore income through mechanisms like increased international information sharing and increased enforcement; (5) increased research; (6) improvement of information technology; (7) increased the number of enforcement personnel; (8) enhanced service to taxpayers; (9) simplification of the tax law; (10) increased regulation of tax preparers; and (11) increased educational

<sup>2 [</sup>hereinafter Update on Tax Gap]. The net tax gap, which includes revenue from late payers and from enforcement actions, is estimated at approximately \$290 billion per year. Id. The data supporting these figures comes from the 2001 tax year and before, and thus the current tax gap could be considerably larger. Id. In addition, the data did not include the effect of the international tax gap. Treasury Inspector General for Tax administration, Ref. 2009·IE-R001, a Combination of Legislative Actions and Increased IRS Capability and Capacity are required to reduce the Multi-Billion Dollar U.S. International Tax Gap (2009), available at http://www.treas.gov/tigta/iereports//2009reports/2009IER001fr.html. Some estimate that the tax gap might be as high as \$400 billion annually. Michael Joe, Officials Voice Support for Steps to Reduce Tax Gap, 121 Tax Notes 144 (2008) [hereinafter Joe, Officials Voice Support].

<sup>5</sup> Update on Tax Gap, supra note 4, at 4.

See, e.g., Amy S. Elliott, IRS Officials Address Increase in Use of Correspondence Exams, Other Programs, TAX NOTES TODAY, Oct. 30, 2008, available in LEXIS 2008 TNT 211-5. Indeed, the IRS has sometimes gone too far in the name of efficiency. For example, the IRS has adopted certain preferential enforcement techniques that reduce audit times at considerable cost to the rule of law. See W. Edward Afield, Agency Activism as a New Way of Life: Administrative Modification of the Internal Revenue Code Through Limited Issue Focused Examinations, 7 Fla. Tax. Rev. 455 (2006).

efforts.<sup>7</sup> If successfully employed, the IRS hopes that these proposals will result in an 86% voluntary compliance rate for the 2009 tax year (an improvement of only 2.3%).<sup>8</sup>

Most of these techniques are based on a traditional theory of law enforcement in which compliance is achieved through a combination of increasing the probability of detection and/or increasing the potential penalty. Although not receiving as much attention as other proposals, improved taxpayer education and preparer regulation indicates that the IRS is aware that this traditional concept of enforcement is insufficient to improve tax compliance significantly because factors apart from the fear of punishment can influence tax compliance. This awareness is a positive development in tax enforcement, although solutions based on a broader view of what drives tax compliance appear to be in their infancy, based on how many of the proposed solutions focus on traditional enforcement techniques.

The solutions that the IRS is considering are worthwhile, but they are mere stopgaps. In order to achieve a more lasting improvement in compliance rates, the IRS must expand its efforts beyond the traditional theories of enforcement and must adopt strategies that help establish a social norm of tax compliance as an underlying civic virtue. Although scholars have begun to recognize the need for this evolution in enforcement, 11 the current literature has

<sup>&</sup>lt;sup>7</sup> Update on Tax Gap, supra note 4 at 6–28.

<sup>8</sup> Id. at 30.

<sup>9</sup> See infra Part III.A for a fuller discussion of this theory

See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-567, REPORT TO THE COMMITTEE ON FINANCE: IRS SHOULD EVALUATE PENALTIES AND DEVELOP A PLAN TO FOCUS ITS EFFORTS 7-8 (1999) ("In addition, a number of issues other than IRS enforcement activities affect a taxpayer's behavior, including income, tax rates, demographics, and social factors.").

<sup>11</sup> See infra discussion of the various proposals in Part III.C.2.

paid little attention to one significant arena that could help solidify this new norm: potential partnerships between the government and Judeo-Christian religious organizations (hereinafter referred to as "religious organizations"). <sup>12</sup> Such partnerships have potential to effect a culture change by providing more effective forums for taxpayer education than those currently used <sup>13</sup> and by serving as intermediaries between taxpayers and the government. Furthermore, these benefits can be achieved without significantly straining the IRS' already underwhelming resources.

This article illustrates how potential partnerships between the government and religious organizations can impact the norms relating to tax compliance. Part I provides a brief overview of the components of the tax gap and the problems facing the IRS in combating it. Part II focuses on the most substantial component, individual noncompliance, and provides an overview of its possible causes. Part III discusses some of the prominent proposals that scholars have put forth to remedy the tax gap and will attempt to classify them into fundamental categories reflecting their philosophical underpinnings. Part IV shows

I will be restricting my analysis in this piece to proposed partnerships with Judeo-Christian organizations because of how interconnected Judaism and Christianity are and because together they encompass approximately 84.08% of the United States population. See Association of Religion Data Archives, http://www.thearda.com/internationalData/countries/Country\_234\_1.asp (last visited Nov. 1, 2009). Certainly, the restriction of my focus is not meant to imply that other religious and moral traditions have not considered evaluated taxation as a moral issue. For example, see ROBERT W. McGee, The Philosophy of Taxation AND Public Finance 67-69 (Kluwer Academic Publishers 2004) for a discussion of moral issues relating to taxation in Islam.

Current government educational partnerships include "work[ing] with the Small Business Administration to educate new business owners on key tax topics, and expand[ing] work with partners to communicate with military retirees on retirement related tax issues" as well as partnerships with universities and colleges to deliver educational information. Update on Tax Gap, supra note 4 at 26.

how government partnerships with religious organizations can provide an effective mechanism for improving tax compliance by drawing parallels to the success of these types of partnerships in other law enforcement contexts. Finally, I conclude that, while these types of partnerships are certainly not the only solution that should be employed, they represent an effective technique for improving tax compliance that provides benefits to all stakeholders without imposing significant additional costs.

### I. A Brief Overview of the Tax Gap

By far the biggest contributor to the tax gap is underreporting, <sup>14</sup> which constitutes \$285 billion of the total tax gap. <sup>15</sup> Within this category, the individual income tax comprises \$197 billion, contributing to over 50% of the total tax gap. <sup>16</sup> In comparison, corporate taxpayers' contribution to the tax gap is relatively modest—\$30 billion. <sup>17</sup>

Why is this number so large? The most common explanation is that the IRS simply has insufficient resources to enforce the tax code effectively.<sup>18</sup> For example, the IRS blames a 4.7% drop in revenue

Underreporting includes both understating receipts and overstating expenses. *Id.* at 3.

<sup>15</sup> *Id.* at 4.

Id. Not everyone bears an equal burden, however, and, predictably, people with higher incomes exhibit higher levels of underreporting, likely because they are receiving a larger share of their incomes in forms that are tied to higher rates of noncompliance. Andrew Johns & Joel Slemrod, The Distribution of Income Tax Noncompliance, 2 (Working Paper, 2008), available at http://www.bus.umich.edu/otpr/DITN%20091308.pdf. Interestingly, this misreporting percentage peaks at adjusted gross incomes between \$500,000 and \$1 million. Id.

Update on Tax Gap, supra note 4, at 4.

<sup>18</sup> David Cay Johnston, Change and the IRS, TAX NOTES TODAY, Dec. 2, 2008,

collected in 2008 on the fact that the IRS had to reduce its enforcement staff by 2.2% due to budget constraints.<sup>19</sup> These resource limitations force the IRS to ignore information that could lead to collection of large amounts of revenue because these uncollected amounts still pale in comparison to the tax gap's overall size.<sup>20</sup>

available in LEXIS 2008 TNT 232-83 (quoting Charles Rossotti, former Commissioner of the IRS, who stated "The tax system continues to grow in complexity . . . while the resource base of the IRS is not growing and in real terms is shrinking. Basically, demands and resources are going in the opposite direction. This is systematically undermining one of the most important foundations of the American economy.").

- Michael Joe, IRS Enforcement Revenue Slipped During Fiscal 2008, 122 TAX NOTES 22 (2009). The IRS, however, noted that other factors, like a failure to repeat some anomalously large settlements, also contributed to the drop, and that enforcement revenue still exceeded revenue collected in 2006. Id. Lack of resources also affects the speed in which the IRS is able to resolve disputes. Id. The IRS Appeals Office is facing reversals in years of progress in improving case handling times. Sam Young, IRS Appeals Hurt by Budget, Staffing Woes, Chief Says, TAX NOTES TODAY, Oct. 30, 2008, available in LEXIS 2008 TNT 211-9. The IRS is not completely blameless for its personnel shortfalls, however—it has not done a good job of planning for the inevitable attrition of its workforce as the baby boom generation nears retirement. Michael Joe, IRS Unprepared for Wave of Workforce Attrition, TIGTA Says, 120 TAX NOTES 932 (2008). As a result, the IRS currently has been unable to fill some open positions. comprehensive summary of recent trends in tax enforcement activities, see TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2008, Ref. No. 2009-30-082, 1-4, (June 10, 2009), available at http://www.treas.gov/tigta/auditreports/2009reports/2009repor ts/2009reports/200930082fr.pdf (referring to a 5% drop in enforcement revenue and providing statistics as to the levels of various enforcement activities).
- Michael Joe, Fraudulent Returns by Taxpayer on the Rise as IRS Deals with Tight Resources, 121 TAX NOTES 536 (2008) (noting that the IRS does not have the resources to follow every lead necessary to stop the practice of taxpayers filing fraudulent returns to claim refunds, estimated to result in \$1.6 billion of fraud in 2007).

The other explanation is that the IRS has had difficulty balancing the need to enforce the tax code with its desire to assist honest taxpayers. The Internal Revenue Service Restructuring and Reform Act of 1998 caused the IRS to abandon its sole focus on collections and to consider how it could assist taxpayers, a fact that generally pleases IRS staffers.<sup>21</sup> Nevertheless, if the pendulum had swung too far towards enforcement prior to 1998, the pendulum arguably swung back too far towards service after the legislation, and the IRS allowed its enforcement efforts to decline significantly for several years after the Act.<sup>22</sup> Although the IRS has worked hard to achieve an appropriate balance between service and enforcement, trying to maintain this equilibrium takes constant effort.<sup>23</sup> Certainly, increased service can help reduce the tax gap just as increased enforcement can.<sup>24</sup> The tax gap includes uncollected revenue from honest mistakes as well as fraud.<sup>25</sup> Nevertheless, allowing either prong to decline, as the IRS had done with service prior to the 1998 Act and as it did with enforcement subsequent to the Act, will inevitably result in collection problems.

Sam Goldfarb, After Restructuring Act, IRS Is Kinder and Better, Panelists Say, 120 TAX NOTES 304 (2008). See Leandra Lederman, Tax Compliance and the Reformed IRS, 51 U. KAN. L. REV. 971 (2003) [hereinafter Lederman, Reformed IRS] (providing a general overview of the IRS' shift towards a more customer service approach).

Michael Joe, Renewed Focus on Enforcement Appropriate in Wake of 1998 Reforms, Says Shulman, TAX NOTES TODAY, July 21, 2008, available in LEXIS 2008 TNT 140-1.

<sup>&</sup>lt;sup>23</sup> Id.

<sup>&</sup>lt;sup>24</sup> Indeed, "[t]here is ...no reliable data showing that more enforcement rather than more taxpayer service increases compliance." Dave Rifkin, *An Overview of the "Tax Gap"*, TAXES—THE TAX MAGAZINE Nov. 2008, at 7.

The IRS does not disclose what percentage of the tax gap is caused by intentional noncompliance. Stuart P. Green, What is Wrong with Tax Evasion?, 9 Hous. Bus. & Tax L. J. 221, 223 (2009).

Because the IRS is overworked and underfunded, it inherently has to select among various enforcement proposals. Understanding the causes of taxpayer noncompliance is essential to determining which of these strategies will be the most effective. The group that deserves the most attention under such an analysis is the group that contributes the most to the tax gap: individuals. Because individual noncompliance comprises such a large portion of the tax gap, compliance initiatives aimed at the underlying causes of individual noncompliance could lead to a large reduction in the tax gap.

### II. EXPLANATIONS FOR THE CAUSES OF INDIVIDUAL NONCOMPLIANCE

Individual noncompliance (like any noncompliance) can either be intentional or inadvertent. This part will focus on what motivates taxpayers to violate the tax laws intentionally. Although efforts to reduce the tax gap should focus both on eliminating taxpayer error as well as taxpayer fraud, the solutions to eliminating taxpayer error appear straightforward and uncontroversial, even if they are politically difficult to achieve. These solutions would include simplifying the tax code and the corresponding filing requirements and providing better information to taxpayers about what their duties are and how particular transactions should be treated.<sup>26</sup> Potential solutions to

Update on Tax Gap, supra note 4 at 23-24. These solutions are part of a widerange of solutions that the IRS is proposing and that attempt to address both intentional and unintentional errors. Id. Of course, making compliance easier can also go to prevent semi-intentional noncompliance that arises from honest taxpayers becoming frustrated with the tax system's complexity. Jay A. Soled, Homage to Information Returns, 27 VA. TAX REV. 371, 394-95 (2007) [hereinafter Soled, Information Returns]. See also Hope M. Babcock, Assuming Personal Responsibility for Improving the Environment: Moving Toward a New Environmental Form, 33 HARV. ENVTL. L. REV. 117 (2009) [hereinafter Babcock, Assuming Personal Responsibility] for a good overview of the literature about how making compliance easier will actually increase compliance. See also Nicole Duarte & Michael Joe, Improvements in Withholding Compliance Tempered by

remedy intentional noncompliance, however, are controversial because they inevitably involve differing assumptions regarding what drives taxpayer behavior and involve certain tradeoffs among societal values. Indeed, what one considers to be an appropriate solution will often depend on the reasons why one believes taxpayers are intentionally noncompliant.<sup>27</sup> Accordingly, understanding the causes of intentional tax noncompliance is critical in the discussion about proposals to remedy this noncompliance.<sup>28</sup>

Inefficient IRS Follow-Up, TIGTA Says, TAX NOTES TODAY, Sept. 9, 2008, available in 2008 TNT 175-4 for an example of how simplification through the use of "lock in" letters to inform taxpayers that are not complying with their proper withholding obligations how much they should be withholding in order to become compliant. See also Johnston, Change and the IRS, supra note 18, for a summary of various proposals to help address the tax gap, two of which involve making the tax code easier to understand.

- <sup>27</sup> Doran, discussed infra Part II and note 28.
- Although note that one scholar has suggested that perhaps understanding the causes of noncompliance is not as critical as understanding how the government sets the standard of what is considered to be noncompliant behavior in the first place. Michael Doran, Tax Penalties and Tax Compliance, 46 HARV. J. ON LEGIS. 111 (2009). Analyzing the signaling effects of tax penalties, Michael Doran argues that tax penalties play a critical role in not only enforcing tax compliance but in defining what compliant behavior actually is, because taxpayers will change their behavior to avoid the penalty. Id. at 139. Thus, whatever conduct allows avoidance of the penalty inherently defines what conduct the government considers to be acceptable. Id. at 139-40.

For Doran, the problem is that the standards related to the accuracy related penalty are inconsistent with what the government says should be the norm for tax compliance. *Id.* at 140. While the government wants everyone to report their tax liabilities correctly, the accuracy related penalty allows taxpayers to take positions that they know are probably wrong and still escape being penalized. *Id.* at 142. Preparer and practitioner penalties suffer from similar problems. Doran believes that these penalties should all have the same standard and should require people to take positions that they actually think are more likely than not to be correct. *Id.* at 156–58. Doran also believes that this standard should apply

Some scholars have relied on the United States' relatively high tax compliance rate to argue that the United States has a generally positive culture of compliance, particularly in comparison to the rest of the world.<sup>29</sup> This view, however, mistakenly fails to consider that there are vast differences in compliance rates that depend on whether the taxpayer is reporting a transaction about which the government has already been informed.<sup>30</sup> When third parties provide information reporting to the IRS (or even when the taxpayer simply perceives that a record of taxable income might be provided to the government by a

to government officials, who should be punished in promotion and tenure if they take positions that they do not believe in good faith to be correct. *Id.* at 158–60.

Following this logic, the government's implicit endorsement of noncompliant behavior by signaling that it will not be penalized makes correcting noncompliance all the more difficult because taxpayers may in certain circumstances honestly believe that they are complying perfectly with the tax laws by simply taking aggressive positions that they believe are permissible, even if they do not believe them to be correct.

- Richard Lavoie, Flying Above the Law and Under the Radar: Instilling a Taxpaying Ethos in Those Playing by Their Own Rules, 29 PACE L. REV. 637, 638 n. 6 (2009); Dan M. Kahan, The Logic of Reciprocity: Trust, Collective Action and Law, 102 MICH. L. REV. 71, 86 (2003) [hereinafter Kahan, The Logic of Reciprocity].
- See Lederman, Reformed IRS, supra note 21, at 974-5 (noting that reliance upon statistics establishing a high compliance rate despite a low audit rate to support the view of a compliant culture is flawed because this comparison does not consider the effect of information reporting); see also Leandra Lederman, The Interplay Between Norms and Enforcement in Tax Compliance, 64 Ohio St. L. J. 1453, 1460 (2003) [hereinafter Lederman, Norms and Enforcement]. Note also that the overall compliance rate might be understated as well, as private researchers have revealed that 25% of surveyed taxpayers admit to cheating on their taxes. Green, supra note 25, at 223. If such surveys accurately predict the level of intentional noncompliance, then the overall compliance rate (combining both intentional and unintentional noncompliance) is likely much lower than 83.7%.

third party) the taxpayer is considerably more likely to report the income on a return.<sup>31</sup> The difference is particularly striking when one compares the 1% noncompliance rate for wage income (which is almost entirely reported) with the approximately 50% noncompliance rate for cash income.<sup>32</sup> Susan Morse, Stewart Karlinsky, and Joseph Bankman conclude from this data that "[t]he strong relationship between evasion and income source suggests that the primary causal factor that explains evasion is opportunity."<sup>33</sup>

The fact that taxpayers appear to be willing to cheat when they believe that they can get away with it suggests at first blush that taxpayers simply follow a classic rational actor economic model in which taxpayers will base their compliance decisions on "a comparison between (1) the cost of paying tax and (2) the difference between the benefit of avoiding the tax and the cost of the imposition of tax, interest, and penalties, risk-adjusted for the possibility that the

Susan Clearly Morse, Stewart Karlinsky, & Joseph Bankman, Cash Businesses and Tax Evasion, 20 Stan. L. & Poly Rev. 37, 39-40 [hereinafter Morse, Cash Businesses] (citing Joel Slemrod & Jon Bakija, Taxing Ourselves: A Citizen's Guide to the Great Debate Over Taxes 178 (3d ed. 2004) and Internal Revenue Serv. & U.S. Dep't of Treasury, Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance (2007), available at http://www.irs.gov/pub/irs-news/tax\_gap\_report\_final\_080207\_linked.pdf [hereinafter 2007 Tax Gap Report]). See also Rifkin, supra note 24; Richard Winchester, The Gap in the Employment Tax Gap, 20 Stan. Law & Poly Rev. 127 (2009); Sagit Leviner, A New Era of Tax Enforcement: From Big Stick' to Responsive Regulation, 42 U. Mich. J. L. Reform 381, 400-01; Soled, Information Returns, supra note 26.

<sup>&</sup>lt;sup>32</sup> Morse, Cash Businesses, supra note 31 at 39.

<sup>33</sup> Id. at 40. Note that these statistics contrast sharply with what taxpayers claim they believe about whether tax compliance is a virtue. These contrasting figures will be discussed and explained in Part III.C.1. Note also that compliance problems are not restricted to taxpayers acting alone—rather, tax preparers are often complicit in the tax fraud of their compliance, either intentionally or recklessly. Morse, Cash Businesses, supra note 31, at 61-3.

government will successfully challenge the tax avoidance strategy."<sup>34</sup> Most commentators, however, believe that this model provides an overly simplistic view of taxpayer behavior because it does not consider a variety of factors that influence a taxpayer's decision regarding whether to comply with the law.

Applying social norms literature to tax compliance, scholars have identified a variety of factors that influence tax compliance decisions outside of the traditional rational actor formula.<sup>35</sup> These factors include: (1) how issues of taxation are framed for the taxpayer;<sup>36</sup> (2) psychological influences such as the presence in the American "world view" of deeply held anti-tax sentiments;<sup>37</sup> (3) the religious, moral, and ethical attitudes of various taxpayers;<sup>38</sup> (4) taxpayers' trust in government and their perception regarding whether they are obtaining value for their tax dollars;<sup>39</sup> and (5) taxpayers' trust

<sup>34</sup> Id. at 38 (summarizing the seminal description of the economic theory of tax noncompliance found in Michael G. Allingham & Agnar Sandmo, Income Tax Evasion: A Theoretical Analysis, 2 J. Pub. Econ. 323, 326 (1972)).

See Alex Raskolnikov, Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement, 109 COLUM. L. REV. 689; Marjorie E. Kornhauser, A Tax Morale Approach to Compliance: Recommendations for the IRS, 8 FLA. TAX REV. 599 (2007) [hereinafter Kornhauser, A Tax Morale Approach]; Leviner, supra note 31; Lavoie, supra note 29; Dennis J. Ventry, Cooperative Tax Regulation, 41 CONN. L. REV. 431 (2008) [hereinafter Ventry, Cooperative Tax]. But see Doran, supra note 28, who is critical of the social norms approach, although he provides a nice summary of both the traditional and norms-based models.

Kornhauser, A Tax Morale Approach, supra note 35, at 609.

<sup>&</sup>lt;sup>37</sup> *Id.* at 610–12.

<sup>38</sup> *Id.*; Leviner, *supra* note 31.

Lavoie, supra note 29, at 650 ("Within this rubric are such factors as whether the use to which taxes are put are seen as appropriate and of equivalent value to the tax cost and whether the tax laws are perceived as representing an equitable sharing of the tax burden."); Leviner, supra note 31.

that their fellow citizens are not shirking their tax obligations.<sup>40</sup> This norms based model of taxpayer behavior does not seek to eliminate classic rational actor theories of deterrence from the compliance conversation—rather, this approach seeks to complement and expand on the traditional rational actor model by illustrating that many factors apart from simple utility maximization motivate taxpayer choices.<sup>41</sup> The norms model, like the rational actor model, is still

Lavoie, supra note 29, at 655 ("Within this rubric are such factors as whether other taxpayers are perceived as being generally compliant, the ability to place social pressure on noncompliant taxpayers, and the ability to create incentives or rewards linked to compliant behavior."); Kornhauser, A Tax Morale Approach, supra note 35, at 616 ("Acting under a norm of reciprocity, a person may voluntarily comply with tax laws even if s/he does not personally experience fiscal equity in the tax/government benefit exchange because s/he is helping the collective good."); Leviner, supra note 31, at 407 (discussing a study showing that tax compliance decisions were "affected not only by what taxpayers believe they receive for paying taxes and by their relative gain or loss in consumption compared to that of others, but [were] mostly impacted by social interaction and the extent to which noncompliance was perceived to be prevalent in the taxpayers' social environment."); Dan M. Kahan, Reciprocity, Collective Action, and Community Policing, 90 CAL. L. REV. 1513, 1520 (2002) [hereinafter Kahan, Community Policing ("most taxpayers behave like moral and emotional reciprocators: in deciding whether to pay their taxes in full, they are more influenced by their perception that others are or are not complying than they are by the material costs and benefits of evasion."); Cass R. Sunstein, Social Norms and Social Roles, 96 COLUM. L. REV. 903, 945 (1996) ("agents are willing to cooperate, and hence to solve collective action problems without coercion, if most people are seen as cooperators.").

See, e.g., Kahan, The Logic of Reciprocity, supra note 29, at 79 (arguing that people are neither universal cooperators nor universal free-riders and that, accordingly "[m]aximum cooperation, then, probably requires that reciprocity dynamics be supplemented with appropriately tailored incentives, most likely in the form of penalties aimed specifically at persistent free riders."); Doran, supra note 28.

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imperfect, however, because, despite its complexity, it simplifies the enormously varied interaction of norms on an individual.<sup>42</sup>

No one has yet proposed a perfect grand unifying theory of tax compliance.<sup>43</sup> Nevertheless, determining which of the existing models better explains taxpayer noncompliance is an essential component of trying to change noncompliant behavior because taxpayer motivations will dictate what types of solutions should be used. As Michael Doran observes: "the two competing models of taxpayer compliance—the deterrence model and the norms model—pull policymakers in different directions on penalty reform." Solutions to remedy tax noncompliance that take either a deterrence based or norms based approach both have the potential to be effective, although both involve societal tradeoffs. The next part will provide an overview of some of these proposed solutions and show that the most effective are those that actually seek to change the relevant societal norms.

### III. PROPOSED SOLUTIONS TO THE TAX GAP

Many scholars and government officials have proposed various solutions to reduce the tax gap.<sup>45</sup> These proposals can be placed into one of three categories. The first category contains solutions that are based on the traditional rational actor model of deterrence. In the second category are the solutions that determine which taxpayers possess compliance norms and that use this knowledge to make

Doran, supra note 28 at 134.

Id. at 138 ("The questions of why taxpayers comply and how penalties should be structured to promote compliance remain unsettled and controversial...").

<sup>44</sup> *Id.* at 113.

See, e.g., Update on Tax Gap, supra note 4 for a good overview of what the proposed solutions from government are; see also Rifkin, supra note 24, for a good overview of various proposals to reduce the tax gap.

enforcement techniques more effective. The third category consists of solutions that affirmatively try to change taxpayer norms as opposed to simply identifying which taxpayers adhere to a positive compliance norm. Solutions in all three categories have advantages and disadvantages, but solutions in the third category have the most potential for long term reduction of the tax gap.

## A. Proposals Based on the Traditional Rational Actor Model

Under the traditional rational actor model, the most basic solution is to affect taxpayers' economic calculus by increasing the probability of being punished for tax evasion, by increasing the severity of the punishment for tax evasion, or by doing both.<sup>46</sup> This solution could involve simply providing more resources to the IRS to enforce the tax laws.<sup>47</sup> As an alternative (if there were no more resources to give to the IRS), the penalties for noncompliance could be increased significantly to have the desired deterrent effect.<sup>48</sup>

Although conceptually simple, implementing such a solution would likely be politically difficult, if not impossible. The easiest way to increase the probability of detection involves giving the IRS more funding to do its job,<sup>49</sup> an issue on which politicians have not exactly

<sup>&</sup>lt;sup>46</sup> Leviner, supra note 31, at 404 (providing a good explanation of this basic approach, although note that, as will be discussed infra, Leviner's proposed solution eventually focuses on a norms based model). Note also that raising the probability of detection has more of a deterrent effect than does increasing the penalty. Id. at 401; Kahan, The Logic of Reciprocity, supra note 29, at 82–83.

 $<sup>^{47}</sup>$   $\,$  See discussion of the IRS's resource problem in Part I.

<sup>48</sup> Leviner, supra note 31, at 401.

This increase in resources would appear to be money well spent, as there is a tremendous rate of return on the IRS' enforcement budget. Edward A. Morse, Whistleblowers and Tax Enforcement: Using Inside Information to Close the "Tax Gap", 24 AKRON TAX J. 1, 7 (2009) [hereinafter Morse, Whistleblowers] (noting that the IRS took an enforcement budget of \$7 billion and used it to

been eager to campaign.<sup>50</sup> Raising the penalties suffers from problems as well, because in order to have an appreciable effect, the penalties would need to be raised to such a high level that "inflicting heavy penalties on the rare few that are caught [would be] arbitrary, draconic, and highly discriminatory."<sup>51</sup>

Faced with the prospect that direct deterrence methods are politically unviable, scholars focusing on aligning financial incentives to encourage tax compliance have attempted to determine other ways to influence taxpayers that would involve neither increasing the IRS's resources nor raising the penalty rate. These solutions have focused on taking some of the pressure off of government by having taxpayers police themselves and their neighbors, either voluntarily or mandatorily.

One such proposal involves strengthening a program that already exists: the IRS whistleblower program.<sup>52</sup> Although its details are predictably complex, the program boils down to rewarding informants who provide information about instances of tax noncompliance.<sup>53</sup> Use of a reward system can help the government use

collect \$59.2 billion in unpaid taxes in fiscal year 2007).

A main task of any I.R.S. commissioner ... is to beg Congress and the White House for resources. For all the obvious appeal of having the I.R.S. collect every dollar owed to the government, it is just as obviously unappealing for most politicians to advocate a more vigorous I.R.S. Michael Dukakis tried this during his 1988 presidential campaign, and —well, it didn't work.

Stephen J. Dubner & Steven D. Levitt, *Filling in the Tax Gap*, THE NEW YORK TIMES, April 2, 2006.

<sup>&</sup>lt;sup>50</sup> Kahan, The Logic of Reciprocity, supra note 29, at 84-85;

Leviner, supra note 31, at 402.

This program is codified in I.R.C. § 7623.

<sup>53</sup> See Morse, Whistleblowers, supra note 49 (providing a detailed overview of the whistleblower program).

its resources much more efficiently by prioritizing its auditing efforts towards taxpayers that are more likely to have done something wrong.<sup>54</sup>

Dennis Ventry takes the concept of incentivizing citizens to police themselves for tax compliance a step further by proposing that taxpayers be permitted to file *qui tam* suits on behalf of the government for tax fraud and be permitted to receive a percentage of any eventual recovery. <sup>55</sup> Ventry recognizes that this private enforcement of the tax laws would be an effective remedy to the problem of the government not having sufficient resources for effective enforcement activity. <sup>56</sup> In addition to mitigating the resource problem, Ventry identifies another advantage to private enforcement: whistleblowers are better than the IRS at identifying noncompliance, likely because they are closer to the noncompliance, and do not suffer from the same information disparities as the government. <sup>57</sup>

Rewarding informants serves as a creative way to increase the probability of detection under the rational actor model by having

<sup>&</sup>lt;sup>54</sup> Id. at 12 ("Informants have increased the dollars returned per hour invested by the IRS, nearly doubling the proposed adjustment per hour over the [the standard statistical auditing technique the IRS uses] sample. Moreover, informants have apparently reduced the number of no-change audits, thereby saving scarce government resources and benefiting compliant taxpayers.").

Dennis J. Ventry, Jr., Whistleblowers and Qui Tam for Tax, 61 TAX LAW. 357, 359 (2008) [hereinafter Ventry, Qui Tam for Tax].

<sup>56</sup> Id.

Id. at 366. Although the superior ability of whistleblowers to ferret out noncompliance could also be a symptom of the IRS's budget constraints. Id. at 378. Ventry acknowledges that the IRS does not have an experience advantage over the private sector because IRS agents are often poorly trained and possess extremely basic knowledge. Id. at 379-81 (discussing David Schizer's proposal to enlist the tax bar to help remedy this experience disparity, citing David M. Schizer, Enlisting the Tax Bar, 59 Tax. L. Rev. 331, 331 (2006)).

citizens perform the IRS's initial investigatory work for it.<sup>58</sup> In addition, the program provides a financial incentive for vigilant taxpayers with helpful information to share it with the government. Edward Morse believes that, although some taxpayers might be motivated to come forward with information about their noncompliant neighbors on moral grounds, the whistleblower program's significant financial incentives are likely the primary factor motivating an informant to come forward.<sup>59</sup> Morse's view may underestimate the fact that simple revenge or disgruntlement might be motivating large numbers of informants more than any potential financial gain.<sup>60</sup> Nevertheless, regardless of whether the program is successfully incentivizing taxpayers through greed or revenge, the program illustrates how the government can still rely on the rational actor model without taking any major additional enforcement steps and without dramatically increasing penalties.<sup>61</sup>

An alternative approach to providing positive incentives for taxpayers to police themselves is to mandate steps that taxpayers

Although note that a survey revealed that small noncompliant cash businesses were actually more concerned about underreporting providing an opportunity for employee theft than with it subjecting the taxpayer to the risk that an employee might become a whistleblower. Morse, *Cash Businesses*, *supra* note 31, at 55–56.

Morse, Whistleblowers, supra note 49, at 32.

Jeremiah Coder, ABA Tax Section Meeting: IRS Whistle-blower Office Sees Jump in Claims, Official Says, 120 TAX NOTES 1139 (2008).

<sup>61</sup> Indeed, Congress has perhaps recognized that these solutions provide a nice workaround for its desire to increase government revenue without actually taking the politically unpopular steps of allocating more enforcement resources or increasing penalties. In recent years there has been a notable change in congressional attitudes towards private enforcement and whistleblowing. Ventry, Qui Tam for Tax, supra note 55, at 357–58. For example, these programs were considered distasteful as recently as the late 1990's, and today the rhetoric discussing these programs hails them as examples of civic virtue. Id.

must take to increase the probability of the government detecting noncompliance. These requirements would be enforced with penalties for failure to comply. Capitalizing on the tremendous success that information returns have had in ensuring a high level of compliance, Jay Soled proposes expanding the circumstances in which an information return is obligatory.<sup>62</sup> These circumstances could include the following: (1) requiring having basis information for securities and pass through entities reported; (2) requiring donees of a taxable gift to file an information return (or requiring the donee to indicate on his/her personal income tax return whether he has been the recipient of any gifts during the year); (3) requiring information reporting for payments made to service providers who operate in corporate form; and (4) requiring additional detail relating to the reporting of interest on real estate financing as well as real estate taxes.<sup>63</sup>

On its face, increasing third party reporting should significantly increase tax compliance under the rational actor model by increasing the probability that noncompliance will be detected. Such an effect might be overstated, however, because increased third party reporting often does not have as significant of an effect as one might suspect.<sup>64</sup> For example, businesses appear to report their credit card receipts as

<sup>62</sup> Soled, *Information Returns*, supra note 26, at 377.

<sup>63</sup> Id. Soled would like to go even further than these increased information reporting requirements. In order to make the underground cash economy more plainly visible to the IRS (visibility being the fundamental purpose of any type of information reporting), Soled proposes that buyers be prohibited from using cash in transactions that exceed \$500. Id. at 396. Recognizing that consumers might balk at this (because currently cash purchases are often discounted because they enable the seller to commit tax fraud more easily), Soled propose that "the quid pro quo for curtailing cash transactions would be a revenue-neutral across-the-board 10% tax reduction, to be offset by the tax revenue generated on the newly transparent underground economy." Id.

Morse, Cash Businesses, supra note 31, at 56–63; Ventry, Cooperative Tax, supra note 35 at 435; Joe, Officials Voice Support, supra note 4.

taxable revenue, despite the fact that there is currently no third party reporting for these receipts.<sup>65</sup> Even when increased information reporting proposals have been implemented, their effect is small compared to the tax gap's overall size.<sup>66</sup>

A second proposal that involves mandatory self-policing is Keith Fogg and Calvin Johnson's proposal that taxpayers be required to file amended returns within sixty days of discovering a material error on an original return, provided that the statute of limitations has not expired.<sup>67</sup> Currently, there is no obligation to file an amended return, and filing such a return is treated more as an ethical obligation than a legal duty.<sup>68</sup> "Ethical obligations, however, state our common values. The ethical norms against deceit against one's nation should be enforced by law. Moving the obligation from the realm of ethics to that of law means that tax professionals will help enforce the duty."<sup>69</sup> Although such a proposal is appealing in that it makes a taxpayer's

This year [2008], Congress enacted a provision in the Housing and Economic Recovery Act of 2008 (P.L. 110-289) to require merchants to report information on payment card and third-party network transactions, which is estimated to raise \$9.5 billion over 10 years. And securities brokers are now required to report to the IRS their cost basis information for stock and other securities transactions—a provision in the catchall financial bailout bill (P.L. 110-343) intended to help offset \$17 billion in renewable and clean energy provisions by raising an estimated \$6.7 billion over 10 years.

The fact that the impact is relatively small does not mean that these strategies should not be pursued—it only means that the benefits are not as large as one might suspect, indicating that additional strategies should be adopted.

<sup>65</sup> Morse, Cash Businesses, supra note 31, at 50.

<sup>66</sup> Joe, Officials Voice Support, supra note 4:

Keith Fogg & Calvin Johnson, Amended Returns — Imposing a Duty to Correct Material Mistakes, 120 TAX NOTES 979, (2008).

<sup>68</sup> *Id.* 

<sup>69</sup> Id.

legal obligations consistent with his ethical ones (after all, if taxpayers have an obligation to file a correct return, they should have an obligation to correct that return if they later discover it to be incorrect), it would be unlikely to increase revenue considerably.<sup>70</sup>

Finally, in addition to using the rational economic model to tailor incentives towards taxpayers and informants, the model can also be used to attack the very heart of more sophisticated abusive activity: unscrupulous tax practitioners and tax shelter promoters. Discussing the effects of tax malpractice litigation, Jay Soled proposes that malpractice suits should be made an even more powerful weapon for plaintiffs by removing procedural difficulties to bringing suit that unduly favor defendants, increasing rewards for successful plaintiffs, and increasing guilty defendants' economic exposure as well as the negative publicity that would accompany a successful plaintiff's verdict. As a result, "[t]he downside risk of participating in abusive

Increased information reporting requirements would likely raise more revenue than a mandatory amended return requirement because the information reporting requirements would inevitably affect a large number of taxpayers. As discussed supra, even these increased information reporting requirements would not decrease the tax gap by a significant percentage. See note 66 and corresponding text.

Jay A. Soled, Tax Shelter Malpractice Cases and their Implications for Tax Compliance 58 AM. U. L. REV. 267, 315-330 (2008) [hereinafter Soled, Tax Shelter Malpractice. Soled proposed that procedural reforms could include "tolling the statute of limitations in the tax shelter malpractice context and nullifying the vast majority of arbitration clauses connected with abusive tax shelter representation. . ." Increasing potential for recovery could be *Id.* at 322. accomplished by: (1) prohibiting abusive tax shelter promoters from relying on a "mere error in judgment defense"; (2) allowing "taxpayers to recover the difference between (i) the interest charge imposed on their delinquent taxes and (ii) the income taxpayers earned on their unpaid tax dollars"; and (3) permitting easier recovery of penalties in malpractice cases in order to encourage taxpayers to settle with the IRS. Id. at 66-7. Increasing the economic and reputational exposure of a successful plaintiff's verdict could be accomplished by prohibiting "insurance carriers from covering acts associated with the promotion of abusive

tax shelters would go up by several orders of magnitude. In terms of ensuring the integrity of our tax system, this would be a good thing."<sup>72</sup> Such a proposal builds on the concept of providing financial incentives for taxpayers to police each other but recognizes that it is insufficient to increase the probability of detection or the severity of the penalty for taxpayers themselves. Rather, it is critical to affect the compliance decisions of tax promoters who rely on the Tax Code's complexity to convince taxpayers that they have devised methods to exploit this complexity.

Solutions based on the rational actor model have merit and certainly can increase tax compliance to a degree. They are inherently limited, however, because they do not take into account the various behavioral factors that determine whether a taxpayer will adhere to a positive compliance norm.<sup>73</sup> Indeed, as Dan Kahan observes, failure to recognize these other factors can actually cause increased enforcement efforts to encourage noncompliance:

Researchers have also found that highly politicized auditing

tax shelters" and by publishing the names of penalized abusive tax shelter promoters. *Id.* 

<sup>&</sup>lt;sup>72</sup> Id. at 331.

See, e.g., Kornhauser, A Tax Morale Approach, supra note 35; Morse, Cash Businesses, supra note 31; Ventry, Cooperative Tax, supra note 35; Raskolnikov, supra note 35; Lavoie, supra note 29. Note that some of these rational actor solutions do potentially tap into more complicated elements that influence compliance norms. For example, Dennis Ventry observes that his proposal to allow qui tam actions for tax noncompliance could be effective because he believes that tax compliance is becoming viewed as a civic virtue. Ventry, Qui Tam for Tax, supra note 55 at 384. But see Part III.C.1. for a discussion of whether this compliance norm really exists in American culture. Ventry still acknowledges, however, that he believes that fear of being caught is what primarily drives tax compliance decisions, and that qui tam actions would be most useful in increasing this fear of detection. Id. at 406.

campaigns tend to provoke a higher incidence of tax cheating rather than a lower one . . .

The mechanism for these effects appears to be social cueing. When government engages in dramatic gestures to make individuals aware that the penalties for tax evasion are being increased, it also causes individuals to infer that more taxpayers than they thought are choosing to cheat. This distrust of one's neighbors triggers a reciprocal motive to evade, which dominates the greater material incentives to comply associated with the higher-than-expected penalty.<sup>74</sup>

Recognizing this problem, scholars have proposed solutions that complement the traditional rational actor model and attempt to tap into some of these underlying factors influencing compliance norms.

#### B. Proposals Based on the Taxpayer Norms Model

In light of the research indicating that, in addition to a classic economic rational actor calculus, complex behavioral factors drive taxpayers' compliance decisions, scholars have begun to propose creative solutions that attempt to tap into these behaviors. These solutions have taken the form of manipulating psychological traits in order to create more effective punishments under the rational actor model;<sup>75</sup> trying to tailor punishments only towards those taxpayers that are predisposed to intentional noncompliance;<sup>76</sup> and trying to

<sup>&</sup>lt;sup>74</sup> Kahan, The Logic of Reciprocity, supra note 29, at 83; <u>but see Lederman, Norms</u> <u>and Enforcement, supra note 30, at 1499</u>.

Jay A. Soled & Dennis J. Ventry, A Little Shame Might Just Deter Tax Cheaters, USA TODAY, April 10, 2008, at 12A [hereinafter Soled, Shame].

See, e.g., Raskolnikov, supra note 35; Leviner, supra note 31, at 410–424.

create an environment conducive to reciprocal compliance among taxpayers.<sup>77</sup>

#### 1. Shaming

Norms based proposals do not abandon deterrence under the rational actor model.<sup>78</sup> Indeed, some scholars have still focused their proposals on simply increasing the severity of the punishment for noncompliance (a staple of the traditional rational actor model). Rather than proposing tangible punishments such as fines or loss of freedom, however, they have sought to determine whether taxpayers' psychological attitudes could be manipulated to create more negative consequences for noncompliance. The solution under this theory that has received considerable scholarly attention is the use of shaming to increase tax compliance.<sup>79</sup> Under this approach, the government would publish the names of delinquent federal taxpayers so that their sense of embarrassment would encourage them to pay any outstanding tax obligations and would motivate them to be more compliant in the future.<sup>80</sup> Such programs have already been successful on the state level: "More than 20 states and the District of Columbia have filled public coffers with payments from delinquent taxpayers whose names and addresses were published on state government websites. Shaming has helped states collect hundreds of millions of dollars in unpaid tax bills as taxpayers have rushed to expunge their names from the lists."81

<sup>&</sup>lt;sup>77</sup> See, e.g., Kahan, The Logic of Reciprocity, supra note 29, at 80–85.

<sup>&</sup>lt;sup>78</sup> See note 41 and surrounding text.

<sup>&</sup>lt;sup>79</sup> Ventry, Shame, supra note 75. See also Leviner, supra note 31, at 385.

<sup>80</sup> Ventry, Shame, supra note75.

<sup>81</sup> *Id.* 

Assuming that the necessary social norm of feeling guilty about noncompliance has taken hold in society, shaming can be effective.<sup>82</sup> If shaming is not implemented properly, however, noncompliance can actually increase. Widespread shaming campaigns can lead taxpayers to believe that most of their peers must be cheating on their taxes, which can in turn crowd out good behavior.<sup>83</sup> In order to counter this effect, the IRS would likely have to prove that the majority of taxpayers are in fact compliant by providing greater public access to tax return information.<sup>84</sup> A reduction of taxpayer privacy rights might prove unpalatable to Americans, who are used to their taxpayer information being protected.<sup>85</sup>

#### 2. Targeted Tax Enforcement

Problems can also arise with the effectiveness of shaming if the public identifies with the offender. People observing the shaming must agree that the person and the activity she engaged in are bad. Otherwise they will not 'ostracize' that person—in fact, they might applaud her and her individualistic behavior, as in the case of the solo commuter, enhancing her reputation as a norm violator.

Babcock, Assuming Personal Responsibility, supra note 26, at 162-63. But see, e.g., Lederman, Norms and Enforcement, supra note 30, at 1513 ("[a]lthough enforcement of the tax laws by the IRS and fostering of a compliance norm are sometimes viewed as inconsistent, the evidence suggests that enforcement does not undermine compliance norms").

Lavoie, supra note 29, at 121. As will be discussed in Part III.C.1., shaming, as well as other proposals that attempt to tap into compliance norms, often are based on the assumptions of a culture of taxpayer compliance that may not be correct. If compliance is not in fact a highly established norm, shaming could be ineffective:

Lavoie, supra note 29, at 120-21; Kahan, The Logic of Reciprocity, supra note 29, at 85.

<sup>84</sup> Lavoie, *supra* note 29, at 120–21.

<sup>85</sup> See Doran, supra note 27, at 135–36.

The use of shaming represents a more expansive approach to enforcement under the rational actor model. Other norms based approaches have attempted to go even further by providing a mechanism for a more efficient use of the rational actor model. These approaches try to achieve these efficiency improvements by targeting tougher enforcement mechanisms towards intentionally noncompliant taxpayers, as opposed to towards the entire taxpaying population.

One example of such a proposal comes from Sagit Leviner, who argues for a more cooperative model of tax enforcement.86 Under Leviner's proposal, the United States would benefit by adopting an enforcement mechanism similar to that used in Australia in which detection and enforcement are used in combination with non-punitive measures to increase the overall compliance rate.<sup>87</sup> Under this approach, the government's first response to noncompliance would be one of cooperation with the taxpayer to resolve the issue.88 If the taxpayer responded cooperatively in return, the government would proceed to provide even more favorable treatment to the taxpayer.<sup>89</sup> If the taxpaver initially resisted the government's overtures, then the government would gradually become more confrontational with the taxpayer.90 The purpose behind such a system "is not only to enforce compliance where none is present but also to strengthen and manage compliance fairly and efficiently, such that voluntary reporting may improve."91

<sup>86</sup> Leviner, supra note 31, at 381.

<sup>87</sup> Id. at 428.

<sup>88</sup> Id. at 417.

<sup>89</sup> Id.

<sup>90</sup> Id.

<sup>91</sup> *Id.* at 426.

Alex Raskolnikov offers another such proposal. Raskolnikov proposes a dual option tax enforcement system in which the traditional system is complemented by a voluntary compliance regime that taxpayers could elect. The tradeoffs of electing the voluntary compliance regime would be that taxpayers would make certain sacrifices (such as agreeing that all ambiguities be resolved in favor of the government and requiring binding arbitration) in exchange for lower penalties. Under the traditional regime, the taxpayers' rights would remain unchanged, although the potential penalties would be increased. Raskolnikov argues that this system would allow the IRS to separate tax gamers (who would often prefer the traditional regime because of a desire to preserve rights against the government) from tax non-gamers (who most likely would not be as concerned about waiving certain benefits that primarily advantage gamers provided that the penalties that were being imposed were lower).

Supporters of these targeted tax enforcement models make a compelling argument that, assuming that the proposals could be implemented effectively, the government would realize increased efficiencies in tax enforcement.<sup>96</sup> The primary problem with these

<sup>92</sup> Raskolnikov, supra note 35, at 690.

<sup>93</sup> Id. at 692.

<sup>94</sup> Id. at 690.

<sup>95</sup> Id. at 692-93. Such a proposal, if successful, would certainly help remedy a problem that the IRS acknowledges exists. "Because the IRS cannot differentiate good, compliant taxpayers from bad, aggressive ones, [senior advisor to the IRS commissioner Richard] Harvey argued, the IRS is forced to impose more onerous requirements on all taxpayers." Lee A. Sheppard, News Analysis: IRS Looking for a Few Good Taxpayers, 121 TAX NOTES 891, (2008).

This assumption, however, is a pretty big one. Raskolnikov observes that, in order to be successful, these targeted tax enforcement models likely require two sets of auditors (a confrontational set and a cooperative set). Raskolnikov, supra note 35, at 707. He reached this conclusion after learning that, when the cooperative tax enforcement regime was implemented in Australia, the auditors

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types of solutions is that they are not ambitious enough. These solutions focus on accomplishing results by separating the intentionally noncompliant taxpayers from the taxpayers that are making good faith efforts to comply with the tax laws.<sup>97</sup> What these proposals do not do, however, is encourage intentionally noncompliant taxpayers to become more honest.<sup>98</sup> Knowing who to target for

had a difficult time adjusting to it because they were comfortable taking confrontational approaches but did not know how to engage in cooperation with taxpayers. *Id.* at 737. If the IRS is really going to have two sets of auditors, such a system would require either massive retraining or massive hiring, both of which can be quite costly. *See* Lawrence Zelenak, *Tax Enforcement for Gamers: High Penalties or Strict Disclosure Rules*, 109 COLUM. L. REV. 55, 62 (2009) [hereinafter Zelenak, *Tax for Gamers*].

- Although, perhaps these proposals would not be as successful at identifying intentionally noncompliant taxpayers as the authors hope. For example, under the Leviner proposal, taxpayers predisposed to noncompliance might actually increase their noncompliant behavior under the assumption that, if they are discovered, they could hopefully engage in cooperation with the government to attempt to limit their liability. See Leviner, supra note 31. In addition, while the proponents of targeted tax enforcement recognize the multitude of complex behaviors that drive tax compliance decisions, they are perhaps underestimating how difficult these complex motivations might make separating the wheat from the chaff. See Doran, supra note 27, at 129–30 (arguing that it is difficult to separate taxpayers into different types because of the various factors that influence tax compliance decisions).
- 98 As noted by Lawrence Zelenak in his response to Raskolnikov's article, Raskolnikov himself recognizes this point:

Although some aspects of the proposal might serve both separating and targeting goals, Raskolnikov explains that the two aspects of the CR that he discusses in the greatest detail-mandatory binding arbitration and a strong progovernment presumption-serve only the separating goal: "[They] do not strengthen a sense of duty, trust in government, or feelings of reciprocity. These features are unrelated to targeting.

Zelenak, Tax for Gamers, supra note 96, at 62 (quoting Raskolnikov, supra note 35, at 739).

enforcement can certainly increase the overall tax compliance rate, but it will not yield nearly as many dividends as programs that could successfully cause more taxpayers to believe that gaming the system is unacceptable. Without this cultural shift, targeted enforcement may only result in modest gains because "[e]ven if public enforcement were stepped up by enhancing government resources, private innovation would outstrip it due to information asymmetries."<sup>99</sup>

#### 3. Tapping Into the Reciprocity Norm.

Shaming and targeted tax enforcement are based on the premises that more than a simple economic maximization model motivates taxpayers and that not all taxpayers are prone to cheat up to the point at which they believe that they will be caught. These types of proposals, however, still depend on a large percentage of taxpayers making some sort of rational choice under a deterrence model (i.e., shaming is based on the concept that some taxpayers will consider being shamed to be a significant deterrent and targeted enforcement by definition is based on the belief that some taxpayers are choosing to be noncompliant under a traditional deterrence analysis). Another norms-based approach, however, grounds its proposals on the fact that the bulk of taxpayers adhere not to a traditional deterrence norm but rather to a reciprocity norm. 100

Dan Kahan has suggested that, because he believes that most taxpayers base their compliance decisions on whether they observe their fellow citizens complying with the tax laws, the government could tap into this norm and increase tax compliance through policies that promoted trust among taxpayers. 101 These policies would be geared

<sup>99</sup> Ventry, Cooperative Tax, supra note 35, at 459.

<sup>100</sup> See note 40 and surrounding text.

<sup>101</sup> Kahan, Community Policing, supra note 40, at 1519.

towards causing taxpayers to realize that their fellow citizens generally comply with the tax laws. 102 Although such proposals are inherently subject to challenge on the grounds that they would require a significant rollback of taxpayer privacy rights in order to provide the requisite proof of taxpayer compliance, 103 Kahan believes that significant compliance gains could be achieved with relatively little effort by "simply informing individuals that tax-compliance rates in the United States are admirably high". 104

A reciprocity based plan of increasing taxpayer trust could be successful if the underlying assumptions (i.e., that taxpayers are reciprocators and that American taxpaying culture is a fundamentally compliant one) are true. Such a plan solves one of the weaknesses inherent in the targeted enforcement proposals by encouraging noncompliant taxpayers to become more compliant. This system potentially breaks down, however, if the underlying assumption about America possessing a highly compliant taxpaying culture is invalid. If

Unfortunately, public officials often do just the opposite. Competing with other agencies and programs for appropriations, the IRS routinely exaggerates the inadequacy of its own enforcement powers and the resulting extent of evasion. Usually timed to be reported on the media the week before personal income taxes are due, IRS-generated stories of the agency's own inefficacy in enforcing the law predictably generate resentment in those who routinely obey. "Are you a Chump?" a Forbes magazine cover story asked its tax-paying readers as the magazine reported on the supposed decimation of the IRS's enforcement capacity.

Kahan, The Logic of Reciprocity, supra note 29, at 84–85. See also Transactional Records Access Clearinghouse, The "April Effect" — IRS Prosecutions Timed for Tax Season, 120 Tax Notes 975, (2008) (indicating that tax prosecutions do in fact increase shortly before the April filing deadline).

<sup>102</sup> Id. at 1520.

<sup>&</sup>lt;sup>103</sup> Doran, *supra* note 28, at 135–36.

<sup>104</sup> Kahan, Community Policing, supra note 40, at 1520. As Kahan points out, however:

American taxpaying culture is fundamentally noncompliant, then the most beneficial proposals would be those that aggressively seek to change this culture and move it more towards embracing compliance.

#### C. Proposals That Attempt to Change the Culture Regarding Tax Compliance

Some recent proposals have recognized that Americans might not be as fundamentally complaint as the statistics indicate. Accordingly, these proposals have recognized the need for a more ambitious agenda: a reformation of American attitudes toward tax compliance. These proposals only have value, however, if taxpayers have an inherent proclivity to noncompliance. As will be seen, such an inclination likely exists today, although this certainly has not always been the case.

#### 1. The Evolution of American Taxpayer Attitudes: Progressing Towards an Inconsistent Patriotism

Through examining how popular culture has treated tax compliance over time, Lawrence Zelenak has illustrated how taxpayer attitudes regarding whether payment of taxes is a civic virtue have changed dramatically over the past several decades. <sup>105</sup> After the income tax's scope was expanded dramatically during World War II, initial references to this new obligation in popular culture were positive and patriotic. <sup>106</sup> Zelenak argues that this initial patriotic

Lawrence Zelenak, Justice Holmes, Ralph Kramden, and the Civic Virtues of a Tax Return Filing Requirement, 61 TAX L. REV. 53 (2007) [hereinafter Zelenak, Civic Virtues].

<sup>106</sup> Id. at 60-65 (noting positive references to taxation found in a range of media, from a song by Irving Berlin to television and/or radio episodes of The Honeymooners, The Adventures of Ozzie and Harriet, Life With Luigi, and the Bill Dana Show).

attitude towards taxation was likely due in part to the fact that the tax system was more transparent and simple and due also to the fact that citizens had a higher trust in government during this time period. 107 As the Tax Code's complexity increased, these attitudes began to change, and references to taxation in popular culture became more cynical and reflective of a much more negative attitude towards government generally. 108

Despite the decline in attitudes towards taxes reflected in pop culture, when taxpayers are actually asked about their views towards taxation, their statements "suggest that a nontrivial amount of goodwill toward the return preparation process has survived the increasing complexity of the income tax." <sup>109</sup> More than 80 percent of

<sup>107</sup> Id. at 65-70.

Id. at 66-70. See also Kornhauser, A Tax Morale Approach, supra note 35, at 609-613 (noting that how taxes are framed and what attitudes towards government are held both can have a significant effect on tax compliance currently, taxes are framed very negatively and taxpayers generally hold negative attitudes towards the government). Stuart Green summarizes additional reasons why a norm of tax compliance has difficulty taking hold in modern society: 1) it is difficult to distinguish between evasion and avoidance; 2) the conduct that leads to tax evasion is often very complex; 3) the system could be diluting the seriousness of the crime by conflating a completed act with attempt; 4) the willfulness requirement allows the defense of mistake to be asserted frequently; 5) incredibly low enforcement levels that not only prevent a deterrent effect but also send a message that tax compliance is not that serious of a priority; 6) enforcement can be very arbitrary; 7) it is not easy to determine whether conduct will be enforced civilly or criminally; 8) there's a common perception that everyone is cheating on their taxes (and this perception is in fact bigger than the actual reality of tax compliance; 9) taxes have been demonized politically so that people can rationalize not paying taxes; 10) taxpayers perceive that the Tax Code is unfair and they are unhappy with how revenues are used. Green, supra note 25, at 226-32.

<sup>&</sup>lt;sup>109</sup> Zelenak, Civic Virtues, supra note 105, at 75 (discussing results from the IRS Oversight Board's Taxpayer Attitude Surveys).

taxpayers have consistently stated throughout the past ten years that no amount of cheating on one's taxes is acceptable. In addition, almost all taxpayers either "mostly agree" or "completely agree" with the statements that "it is every American's civic duty to pay their fair share of taxes" and "[e]veryone who cheats on their taxes should be held accountable."

These survey results indicate that taxpayers' words are inconsistent with their actions. On one hand, taxpayers by their own admission appear to support strongly the proposition that they have a civic duty to pay their taxes honestly. On the other hand, as discussed in Part II *supra*, compliance rates plummet when taxpayers believe that they have a better chance of avoiding detection. In addition, current portrayals of taxpayer attitudes in popular culture reflect a negative view of taxation. How can this inconsistency be reconciled? Are taxpayers simply lying when they respond to the IRS Oversight Board's questions?

One possible explanation is that taxpayers are not being dishonest; rather, they are simply being hypocritical by holding society

<sup>110</sup> IRS OVERSIGHT BOARD, 2008 TAXPAYER ATTITUDES SURVEY 2 (Feb. 2009) (indicating range of between 81 and 89 percent of taxpayers who believe that no amount of cheating is acceptable).

<sup>111</sup> Id. at 3. See also Dubner, supra note 50. A recent poll from the Pew Research Center also backs up these figures—according to the poll, 79% of adults claimed that not reporting all income on a tax return was morally wrong. Pew Research Center, A Barometer of Modern Morals: Sex, Drugs, and the 1040, available at http://pewresearch.org/assets/social/pdf/Morality.pdf (March 28, 2006), 1 [hereinafter, Pew Research Center, A Barometer of Modern Morals]. The only other behavior on the survey that received more moral condemnation was married people having an affair. Id.

See Ventry, Qui Tam for Tax, supra note 55, at 376-79 (noting that taxpayers arguably are coming to see tax compliance as a civic virtue, but simultaneously noting that fear of detection continues to be the primary driver behind compliance decisions).

to an ethical standard that they are not willing to adopt themselves. <sup>113</sup> Furthermore, while they may be engaged in dishonest tax related behavior, they still believe that the law should encourage tax compliance. <sup>114</sup> Such a theory is consistent with the fact that, when interviewed, taxpayers who admit to intentional noncompliance do not attempt to justify their actions by arguing that they are doing something good—rather, they freely admit that they simply cheated because of greed. <sup>115</sup>

There is an evident and pervasive difference between people's choices as consumers and their choices are citizens. This is because people are choosing quite different things. . . . Some people seek stringent laws protecting the environment or endangered species even though they do not use the public parks or derive material benefits from protection of endangered species—and even though in their private behavior, they are unwilling to do much to protect environmental amenities. The mere existence of certain environmental goods seems to be highly valued by political participants, even if they are not willing to back up the valuation with dollars in private markets. . . . It is in part for this reason that democratic outcomes are distinct from those that emerge from markets.

Sunstein, supra note 40, at 959. See also Babcock, Assuming Personal Responsibility, supra note 26, at 118 (discussing how, in the environmental compliance arena, citizens often say that they favor protecting the environment while simultaneously engaging in behavior that is needlessly destructive to the environment).

#### 114 Sunstein also wrote:

Because of the governing norms, citizens may *see*k to implement individual and collective aspirations in political behavior but not in private consumption. As citizens, people may *see*k the aid of the law to bring about a social state that they consider to be higher than what emerges from market ordering.

Sunstein, supra note 40, at 960.

<sup>113</sup> According to Cass R. Sunstein:

<sup>115</sup> Morse, Cash Businesses, supra note 31, at 66.

Another potentially explanatory theory is that taxpayers state one view while appearing to hold another because they engage in an internal rationalization process that allows them to view themselves as honest taxpayers adhering to the norm that they profess when in fact they are doing no such thing. Nina Mazar, On Amir, and Dan Ariely observe that people have an ability to be dishonest knowingly while simultaneously maintaining a positive self-image of honesty (which they describe as "self-concept maintenance". They conducted a study of university students who were given various opportunities to be dishonest, which revealed this disconnect between behavior and self-image:

Across a set of six experiments we found support for our theory [of self-concept maintenance] by demonstrating that when people had the ability to cheat, they cheated, but the magnitude of dishonesty per person was relatively low (relative to the possible maximum amount). We also found that, in general, people were insensitive to the expected external costs and benefits associated with the dishonest acts, but they were sensitive to contextual manipulations related to the self-concept. In particular, the level of dishonesty dropped when people paid more attention to honesty standards and climbed with increased categorization malleability 117

If taxpayers behave as these university students did, then it is quite possible that taxpayers believe that they are fundamentally honest while simultaneously engaging in opportunities to flout the tax laws whenever possible. While such hypocrisy could easily lead to cynicism about the possibility for improving taxpayer compliance rates, there is

Nina Mazar, On Amir & Dan Ariely, The Dishonesty of Honest People: A Theory of Self-Concept Maintenance, 45 J. MARKETING RES. 633 (2008) [hereinafter Mazar, Self-Concept] available at http://ssrn.com/abstract=979648.

<sup>117</sup> Id. (brackets added).

hope. Mazar, Amir, and Ariely note that taxpayer honesty can in fact improve if taxpayers' awareness of their own standards regarding honesty is increased. Accordingly, it may be possible to design programs that actually change a taxpayer's attitude regarding whether payment of taxes is an essential component of honest, civic behavior.

#### 2. Proposals Aimed at Creating a Culture Change

If taxpayers are fundamentally prone to dishonesty in payment of taxes (regardless of whether this disposition exists because they believe such dishonesty is acceptable or because they have rationalized their behavior as consistent with their self-conception of being an honest person), significant improvements could be achieved in the tax compliance rate if these attitudes could be changed. Several commentators have proposed how the government could effectuate such a culture shift. These proposals do not discount the value of solutions under the traditional, rational actor model or under the more sophisticated norms based approach. Rather, these proposals implicitly recognize that a more comprehensive attack on the culture surrounding tax compliance is essential for any permanent progress to occur without considerable increases to audit frequency and/or penalty rates.

Marjorie Kornhauser has been the most vocal proponent of efforts to increase what she describes as "tax morale." 119 Kornhauser

<sup>118</sup> Id. at 635-36.

<sup>119</sup> See, e.g., Kornhauser, A Tax Morale Approach, supra note 35, at 599; Marjorie E. Kornhauser, Tax Compliance and the Education of John (and Jane) Q. Tax Payer, 121, 737, (Nov. 10, 2008) [hereinafter Kornhauser, Tax Compliance and Education] (describing her efforts to increase "tax morale"). She certainly has not been the only proponent, however. See, e.g., Lavoie, supra note 29, at 126-53 (proposing a wide-range of programs that could help improve the compliance rate, including proposals based on the rational actor and norms based model as well as proposals based on a norm-changing approach). Note, however, that the

argues that the IRS could increase tax morale if it took steps to try to get tax compliance seen as a civic virtue, much in the same way that the environmental lobby has gotten society to consider environmentalism to be a moral good. 120 Although Kornhauser makes a variety of proposals (including endorsing some of the traditional rational actor and norms based proposals discussed *supra*), 121 she spends considerable time advocating for increased governmental efforts to educate taxpayers directly and through media outreach to increase voluntary compliance. 122 Her proposals include ideas such as: tying tax education into school curriculums, inserting marketing materials into 1040s, and enlisting the help of celebrities to talk about

primary focus of Lavoie's proposals is on rational actor and targeted norms based proposals, as Lavoie proceeds from an assumption that the high overall compliance rate in the United States is indicative of a culture that is fundamentally compliant. *Id. See* Part III.C.1. for a discussion of why this assumption might not be valid.

- 120 Kornhauser, A Tax Morale Approach, supra note 35, at 601.
- 121 Kornhauser makes three "major recommendations":
- 1. The IRS should establish a permanent department or other structure within its organization devoted solely to voluntary compliance issues. Although this structure should address all types of taxpayers, these recommendations cover only individual taxpayers. This Report labels the structure the Behavioral Science Unit (BSU).
- 2. The IRS should adopt a "tax morale" model of compliance that incorporates internal taxpayer motivations and emphasizes a more individualized carrot and stick approach than traditional tax collection models.
- 3. The IRS should implement long- and short-term educational and media programs to encourage voluntary compliance that incorporate the findings of behavioral research.

Id. at 626.

<sup>122</sup> *Id.* at 630-36; Kornhauser, *Tax Compliance and Education, supra* note 120, at 4-7.

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the importance of tax compliance, all with a focus of educating the public about all of the positive programs that are funded with tax dollars. The purpose of these programs would be both to "provide specific knowledge about the role of tax and how the tax system works [and to] encourage attitudes and behaviors that compliance research indicates are associated with higher tax morale and compliance, such as a sense of civic duty, trust, altruism, integrity." 124

These proposals have not simply focused on changing the mindset of taxpayers—they have also focused on changing attitudes prevalent in tax preparers and in tax regulators. Dennis Ventry has argued that changing the compliance norms of tax advisers and regulators can result in significant compliance gains. Currently, existing standards that encourage an adversarial relationship between tax advisors and the government enforce negative compliance norms in these groups. Elevating the standards governing these tax

<sup>123</sup> Kornhauser, A Tax Morale Approach, supra note 35, at 636; Kornhauser, Tax Compliance and Education, supra note 112, at 6. Kornhauser has begun taking Tax Project: realize these goals through her Literacy steps that Elizabeth http://taxprof.typepad.com/files/tax-literacy-project.pdf. Note Branham sees another potential use for celebrities in creating a positive compliance norm—publicizing celebrity tax prosecutions. Elizabeth Branham, Note: Closing the Tax Gap: Encouraging Voluntary Compliance Through Mass: Media Publication of High-Profile Tax Issues, 60 HASTINGS L. J. 1507, 1528 (2009) ("By showing that individuals who choose not to act in accordance with the norm will be punished through the use of nonpecuniary social sanctions, mass media buttresse[s] the idea of compliance as a socially valuable, or 'good,' behavior, and anything else as a violation of social laws.").

<sup>&</sup>lt;sup>124</sup> Kornhauser, A Tax Morale Approach, supra note 35, at 632.

<sup>&</sup>lt;sup>125</sup> Ventry, Cooperative Tax, supra note 35, at 443.

<sup>126</sup> Id. at 477. ("Prevailing standards based on adversarial norms encourage literalist interpretations of the law because such interpretations can provide sufficient authority if challenged and litigated. Meanwhile, practice standards based on a more likely than not norm reinforce a purposive approach to statutory interpretation.").

professionals and creating a more open, participatory method of adopting regulations can force tax advisors and regulators to adopt a culture that embraces achieving a correct result (rather than just a victorious one in an adversarial context), which could potentially lead to a positive shift in the underlying compliance norm driving tax advice. 127

D. Proposals for Changing Norms Have the Greatest Potential but Still Have Not Gone Far Enough

Proposals to change the negative social norms related to tax compliance can pay significant dividends in reducing the tax gap by leading to a lasting shift in how taxpayers view their tax paying obligations. These proposals can lead to more permanent and cost effective solutions than those offered by proposals that simply focus on a rational actor or a norms based approach to increasing enforcement. A changed norm lessens the need for increased enforcement mechanisms because it results in a community being more willing to police itself. 129

With elevated standards, practitioners have to do more than simply rely on statutory language to support a position, particularly in the presence of heightened disclosure requirements. They have to examine additional sources of statutory interpretation (such as legislative intent and public purpose), and they have to evaluate how individual statutes interact with other statutes, as well as how that interaction might reinforce or destroy the underlying purpose of the statutes in combination with each other.

Id. at 477-78.

Public law enforcement and community self-policing are, economically speaking, substitutes for one another. That is, the more a community has of one, the less it needs of the other in order to hold crime in check. . . . In effect, severe penalties

<sup>127</sup> See Id.

<sup>&</sup>lt;sup>128</sup> See Branham, supra note 123, at 1525.

<sup>129</sup> According to Dan M. Kahan:

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Although there are a number of significant obstacles involved in changing a norm for a subject like tax compliance, <sup>130</sup> making such an attempt is not a waste of time because, according to Cass Sunstein, "[e]xisting social conditions are often more fragile than might be supposed, because they depend on social norms to which—and this is the key point—people may not have much allegiance."<sup>131</sup> According to Sunstein, "norm entrepreneurs" can produce "norm bandwagons" in which more and more people begin adhering to a new norm proposed by the norm entrepreneur. <sup>132</sup> As the norm bandwagon grows larger, eventually a "norm cascade" occurs, in which an existing norm transforms into a new norm very rapidly. <sup>133</sup>

Hope Babcock has extended this concept of the norm cascade by arguing that a norm cascade can occur only during specific "republican moments" that create a sense of urgency that brings about a norm shift.<sup>134</sup> Such a republican moment arguably exists currently in the

crowd out and mask the disposition of individuals to contribute to community self-policing, making severe penalties all the more necessary to compensate.

Kahan, Community Policing, supra note 40, at 1525-26.

<sup>130</sup> Hope Babcock discusses some of these difficulties in her analysis of the potential for changing norms related to environmental compliance, another area in which small harms caused by many people add up to damage society extensively. Babcock, Assuming Personal Responsibility, supra note 26, at 117-18. Some of the more intractable problems include: (1) myths about who is primarily responsible for the problem being addressed; (2) the free rider problem inherent when dealing with issues of collective benefit and externalized harm; and (3) the difficulty in relating an abstract norm to more concrete norms and actions. Id.

<sup>131</sup> Sunstein, supra note 40, at 909.

<sup>132</sup> Id.

<sup>133</sup> Id. at 909.

See Hope M. Babcock, Global Climate Change: A Civic Republican Moment for Achieving Broader Changes in Environmental Behavior, 26 PACE ENVIL. L. REV. 1, 2-3 (2009) [hereinafter Babcock, Republican Moment]. Babcock's analysis

discussion over increasing tax compliance because of the massive amounts of long term debt the United States government is incurring through significant increases in spending without offsetting increases in revenue. These republican moments, however, are fleeting, and, if they are to be exploited successfully, require immediate action. 136

The norm-changing proposals that have been discussed *supra* primarily focus on the government itself being a norm entrepreneur in regards to tax compliance. Such an approach is logical because the

focused on changing environmental preservation norms, but it can logically be extended to the issues surrounding tax compliance norms because the disconnect between what citizens say they believe in and what they actually do is similar in both arenas. See discussion in Part III.C.1. In addition, both areas require a norm shift to achieve any lasting improvements in compliance rates (although Babcock argues that a norm change, without additional government incentives, is likely insufficient to bring about desired results in environmental compliance). Id. at 10–11.

See, Kenneth J. Kies, The Obama Budget, 2019, and the Impending Fiscal Nuclear Winter, 123 TAX NOTES 601 (2009). Kies observes:

From March 2008 to March 2009, annual deficits projected by the Congressional Budget Office from 2008 through 2018 increased by \$6 trillion.

. . *.* .

First, federal receipts have fallen through the floor—income taxes in 2009 will raise roughly \$550 billion less than previously expected. Second, expenditures have skyrocketed. In fiscal year 2009 alone, the government is projected to spend \$838 billion more than was expected just 12 months ago. And, third, deficits caused by this huge mismatch in policy can no longer be mitigated with cash surpluses generated by the payroll tax.

Id. For examples of additional commentary on the economic dangers inherent in this expansion of debt, see also Martin A. Sullivan, Economic Analysis: A National Debt Headed Off the Charts, 122 TAX NOTES 1528 (2009); Martin A. Sullivan, Economic Analysis: The Federal Debt: Why Sustainability is Not Enough, 124 TAX NOTES 7 (2009).

<sup>136</sup> Babcock, *Republican Moment*, supra note 134 at 14–15.

government is arguably in the best position to articulate the harm caused by tax noncompliance and to send a message that noncompliance is unacceptable. <sup>137</sup> In addition, focusing on the government as a norm entrepreneur is consistent with the idea that the government must be seen to be promoting tax compliance aggressively as a national virtue because of the risk that taxpayers might conclude that the government implicitly is consenting to a certain amount of tax noncompliance if such efforts are not taken. 138 There is a risk, however, in assuming that the most effective proposals will be those that the government initiates. The government may not always be in the best position to serve as a norm entrepreneur (at least not by itself) because of people's sensitivity to the source of the norm changing message. Although taxpayers appear to be strongly influenced by their peers, broad government statements encouraging tax compliance have proven to be less influential. This could be because negative attitudes towards the government could cause taxpayers to want to do exactly the opposite of what the government asks them to do.140

The fact that some people like to reject social norms is highly relevant to law. For example, a serious problem with legal efforts to inculcate social norms is that the source of the effort may be disqualifying. Such efforts may be futile or even counterproductive. If Nancy Reagan tells teenagers to 'just say no' to drugs, many teenagers may think that it is very good to say 'yes.' It is said that propaganda efforts in the former Soviet Union failed simply because the source of the propaganda was not trusted; hence the government's effort to inculcate norms of its choosing fell on deaf ears. These points bear on the regulation of

See Green, supra note 25, at 222 (suggesting that this message needs to be sent because one of the primary reasons behind tax noncompliance is that there is "widespread confusion over exactly why tax evasion is morally wrong.").

<sup>138</sup> *Id.* at 224 ("In light of how little we spend on enforcing the tax laws, it *see*ms that the tax gap is more or less tolerated.").

<sup>139</sup> Morse, Cash Businesses, supra note 31, at 40-41.

<sup>140</sup> See Sunstein:

Recognizing that the government may not be the best source for changing social norms, some scholars examining norm changing outside of the tax arena have proposed alternative norm entrepreneurs. One of the most powerful sources of authority for norm changing are religious organizations, and, as a result "[o]ften a government concerned with bad norms does best by working with charitable and religious organizations which can have a high level of

social risks—a principal concern of this article—particularly in the areas of teenage smoking and potentially dangerous sexual activity. Efforts by private or public authorities to stigmatize certain acts may have the opposite effect.

Sunstein, supra note 40, at 919. Cf., Babcock, Republican Moment, supra note 134; Kornhauser, A Tax Morale Approach, supra note 35. Indeed, this distrust of the government as a legitimate moral authority in the tax arena is compounded by the fact that public officials often are made very public examples of individuals who have disregarded their tax laws, as evidenced by the recent tax problems of many of President Obama's Cabinet nominees. See, e.g., Robert Pear, Daschle Pays 3 Years of Tax on Use of Car, N.Y. TIMES, Jan. 31, 2009, at A1; Jonathan Weisman, Geithner's Tax History Muddles Confirmation, THE WALL ST. J., Jan. 14, 2009, at A3; Andrew Malcom, Another Obama pick owes back taxes, but it's OK because, now caught, he'll pay up, Los Angeles Times, Mar. 2, 2009; Laura Meckler, HHS Nominee Sebelius Amends Tax Returns, THE WALL ST. J., April 1, 2009, at A4; Matt Keeley (Matt Krantz contributing), Tax Snafus add up for Obama team, USA TODAY, Feb. 5, 2009. In addition, tax issues can be raised as political weapons, which can inherently make taxpayers suspicious of whether the government takes tax compliance seriously or is merely interested in using it as a political tool. See, e.g., Joseph J. Thorndike, Who You Callin' a Tax Cheat?, 123 TAX NOTES 623 (2009) (discussing how President Franklin Roosevelt and Hamilton Fish used the issue of tax compliance as a political tool). These instances have a doubly corrosive effect on compliance norms because they indicate that a variety of public officials perhaps do not take tax compliance seriously and they also indicate that politicians only care about tax compliance issues when they can be used to score political points.

See generally Sunstein, supra note 40; Babcock, Republican Moment, supra note 134.

competence, experience, and trust."<sup>142</sup> While government partnerships with religious organization have received considerable attention in the norm changing literature, <sup>143</sup> they have received only passing treatment in discussions of changing tax compliance norms. <sup>144</sup> These partnerships should be given greater consideration as a mechanism for producing a norm cascade regarding tax compliance.

# IV. USING GOVERNMENT PARTNERSHIPS WITH RELIGIOUS ORGANIZATIONS TO INCREASE TAX COMPLIANCE

Religious values are a critical component of norm changing behavior because of the influence these values have over an individual's self-perception of whether certain types of behavior are morally acceptable. As discussed in Part III.C.1., *supra*, individuals display a remarkable ability to behave dishonestly without actually viewing themselves as dishonest. This cognitive dissonance can be corrected at least partially by presenting reminders of the individual's religious value system, which has the effect of altering the individual's self-conception regarding honesty and reducing an individual's dishonest behavior. As Nina Mazar, On Amir, and Dan Ariely have

<sup>&</sup>lt;sup>142</sup> Sunstein, *supra* note 40, at 952.

See discussion in Part IV.A. See also, Stephen M. Johnson, Is Religion the Environment's Last Best Hope? Targeting Change in Individual Behavior Through Personal Norm Activation, 24 J. ENVIL. L. & LITIG. 119 (2009) (proposing these types of partnerships in order to help improve compliance with environmental norms).

<sup>&</sup>lt;sup>144</sup> See, e.g., Kornhauser, A Tax Morale Approach, supra note 35, at 621-22 (discussing religiosity as a factor that could lead to greater tax compliance).

<sup>&</sup>lt;sup>145</sup> See, e.g., Mazar, Self-Concept, supra note 116. See notes 124–26 and surrounding text.

<sup>&</sup>lt;sup>146</sup> Id. at 39. ("[I]ncreasing people's awareness of their honesty-standards and decreasing the degrees of freedom available to interpret their own actions

observed, however, "the means by which to incorporate such manipulations in scenarios in which people might be tempted to be dishonest (e.g., returning clothes, filling out tax returns or insurance claims) and how to fight adaption to these manipulations remains an interesting and open question." In the tax compliance arena, one method of incorporating these manipulations is through carefully crafted partnerships between the government and religious organizations similar to community policing models that have proven to be successful in reducing crime in other contexts. These partnerships can tap into the increasing trend of scholarship to consider tax policy issues in religious terms and thus can be instrumental in helping to create the desired norm shift.

A. The Success of Government Partnerships with Religious Organizations through Community Policing

Governmental partnerships with religious organizations in which churches serve as intermediaries between citizens and the police and in which churches organize community prayer vigils with police support already have had a successful track record in reducing crime. Tracey L. Meares and Kelsi Brown Corkran illustrate how

[through the use of religious reminders] could be effective remedies for under the radar dishonesty."). The ability of religious reminders to increase an individual's self-perception regarding honestly could explain why religiously observant taxpayers display an even stronger condemnation of tax cheating than non-religiously observant taxpayers. Pew Research Center, A Barometer of Modern Morals, supra note 111, at 12 (showing that 87% of taxpayers who attended church weekly condemned tax underreporting, as opposed to 74% of taxpayers who attended church monthly and 73% of taxpayers who seldom or never attended church).

<sup>147</sup> Id.

See, e.g., Tracey L. Meares & Kelsi Brown Corkran, When 2 or 3 Come Together,
 48 WM. & MARY L. REV. 1315 (2007) (analyzing the interactions of police and

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these partnerships are advantageous both for the government and the religious organizations:

Newly formed connections between churches and the police . . . could produce a new species of social capital to be directed toward violence control. For example, by interacting with church leaders and parishioners, the police likely would gain access to new sources of information to assist them in criminal investigations. Such interactions might make church leaders and parishioners more willing to identify offenders who victimize them, which in turn would allow the police to more efficiently locate offenders. If more offenders are located and arrested, then the certainty of punishment increases and so does the level of formal deterrence. Church leaders, on the other hand, could parlay a stronger relationship with the police to gain better access to municipal government resources. 149

These programs are successful because the churches' position as a moral authority can lead to greater acceptance and adoption of a norm of increased legal compliance. <sup>150</sup> In addition, these partnerships bolster the underlying reciprocity norm that often dictates whether

churches in organizing a prayer vigil on Chicago's West Side); Kahan, Community Policing, supra note 40 (comparing literature analyzing the Chicago prayer vigil with literature analyzing a church police partnership in Boston in which churches provided information to the police in exchange for being allowed to be involved with the disposition of offenders and in exchange for enforcement against police abuse).

<sup>&</sup>lt;sup>149</sup> Meares, *supra* note 148, at 1339.

<sup>150</sup> Kahan, Community Policing, supra note 40, at 1532-33 (observing that people experience less stigma and guilt for providing information to law enforcement because of churches' position as moral authorities and because by involving churches it makes the government enforcement appear less arbitrary and severe).

citizens will adhere to compliance norms.<sup>151</sup> These partnerships have the added benefit of strengthening reciprocity without the negative resentment created by "order-maintenance policing", in which police try to enhance reciprocity by enforcing minor offenses in order to create an environment in which citizens comply with the law because they observe others complying with relatively minor laws.<sup>152</sup>

Could such partnerships be as successful in increasing tax compliance? Undeniably, religious organizations have considerable moral authority when it comes to discouraging violent crime, as religion has condemned violent crimes such as murder since the Ten Commandments. In order for religious organizations to have similar moral authority in regards to tax compliance, there must be a willingness to discuss taxation in religious terms. Fortunately, some scholars have begun this discussion.

When citizens observe church leaders working with the police, they develop a more favorable view of the police. In addition, where the church . . . acts as an intermediary, citizens face less risk in supplying relevant information to law enforcement, and have more reason to believe that supplying it will actually accomplish something. . . .

As citizens start to cooperate more and otherwise become more favorably disposed toward the police, the police form a more positive view of members of the community. . . . The police are thus more disposed to treat citizens with respect in their daily encounters, both because they fear them less and because they value their goodwill more. Treated more respectfully, citizens can be expected to reciprocate by behaving even more cooperatively.

<sup>151</sup> *Id* 

<sup>152</sup> Id. Granted, focusing on small violations to curb a larger noncompliance problem has been shown to be effective in actually remedying noncompliance. See, MALCOLM GLADWELL, THE TIPPING POINT 140-51 (Little, Brown and Company, 2002).

THE CATHOLIC STUDY BIBLE, supra note 1, Exodus 20:13. ("You shall not kill.").

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B. Scholars Have Begun to Discuss Tax Compliance and Tax Policy in Religious and Moral, as Opposed to Purely Economic. Terms

Scholarship that has evaluated taxation through a Judeo Christian lens has focused on two primary areas: (1) whether payment of taxes is a moral obligation and (2) what a tax system that complies with Judeo Christian values would look like. Some of this scholarship overtly applies Judeo Christian moral doctrine by name while other scholarship applies classic Judeo Christian values to taxation without heavily emphasizing the values' religious underpinnings. As a result, the scholars applying these principles have attempted to show how religious and moral values provide guidance in creating an appropriate moral framework for evaluating tax compliance. 154

Although not focusing on specific religious issues, Allison Christians makes a compelling argument for expanding beyond traditional economic analysis of tax policy. Christians argues that tax policy should be evaluated on whether it supports human rights as opposed to being viewed through traditional prisms of equity,

Note, however, that not all scholars who have examined religious views of taxation agree that religious discussions of taxation can provide guidance in the modern world. See, e.g., Chodorow:

Thus, while it may be tempting to look to the examples of taxation in the Bible and Talmud for evidence of what Judeo-Christian values require in a modern, secular tax system, such examples provide little or no guidance when they are placed in contest. As a result, extracting a principle of tax equity or distributive justice from these texts is far more complicated and ambiguous than it might initially appear.

Adam S. Chodorow, *Biblical Tax Systems and the Case for Progressive Taxation*, 23 J.L. & Relig. 101, 144–45 (2007).

Studies Research Paper Series, Paper No. 1066), available at http://ssrn.com/abstract=1272446.

efficiency, and simplicity.<sup>156</sup> For example, currently U.S. companies can reduce their tax burden through foreign owned subsidiaries.<sup>157</sup> While this is an economically efficient result, it hurts human rights by fostering global tax competition that prevents countries in precarious financial positions from raising revenues needed to prevent devastating effects on the poor.<sup>158</sup> Viewing tax policy as a human rights issue, however, "would challenge tax law and legal institutions to be engaged more effectively in the pursuit of equality and improvement in the quality of life of the poor as a matter of right rather than redistribution."<sup>159</sup>

Stuart Green also sees advantages to viewing taxation through a moral lens in order to establish that tax noncompliance is a moral issue. Green argues that tax noncompliance is caused, at least in part, by a societal failure to articulate convincingly why tax evasion is morally wrong. As a result of this failure, society considers tax evasion to be "morally ambiguous" (much like it considers other white collar crimes) in which "there is genuine doubt as to whether what the defendant did was in fact morally wrong. There are several reasons

<sup>156</sup> *Id.* at 1.

<sup>157</sup> Id. at 7.

in direct application of Catholic principles to tax policy. See Pope Benedict XVI, Caritas in Veritate [Encyclical Letter on Integral Human Development in Charity and Truth] ¶ 40 (2009) [hereinafter Caritas in Veritate] ("Paul VI invited people to give serious attention to the damage that can be caused to one's home country by the transfer abroad of capital purely for personal advantage. John Paul II taught that investment always has moral, as well as economic significance.").

<sup>159</sup> Christians, supra note 157, at 2.

<sup>160</sup> Green, supra note 25, at 222-23.

<sup>&</sup>lt;sup>161</sup> Id. at 223.

<sup>162</sup> Id.

for this moral ambiguity: (1) it is difficult to distinguish between evasion and avoidance; (2) the conduct that leads to tax evasion is often very complex; (3) the system could be diluting the seriousness of the crime by conflating a completed act with attempt; (4) the willfulness requirement allows the defense of mistake to be asserted frequently; (5) incredibly low enforcement levels not only prevent a deterrent effect but also send a message that tax compliance is not that serious of a priority; (6) enforcement can be very arbitrary; (7) it is not easy to determine whether conduct will be enforced civilly or criminally; (8) there is a common perception that everyone is cheating on their taxes (and this perception is in fact bigger than the actual reality of tax noncompliance); (9) taxes have been demonized politically so that people can rationalize not paying taxes; and (10) taxpayers perceive that the Tax Code is unfair and they are unhappy with how revenues are used. 163

Green acknowledges that a variety of fixes could potentially be employed in increasing tax compliance. Nevertheless, Green believes that lasting change in compliance levels could occur if tax noncompliance was properly considered to be an actual moral wrong. 165

There are presumably many potential fixes for the just-described state of affairs. We could: (1) simplify the tax code, making clearer the distinction between lawful and unlawful behavior (though we should recognize how difficult this would be, particularly in the context of taxes paid by large businesses); (2) distinguished more clearly between what constitute criminal and civil violations of the code; (3) change our political rhetoric, attempting to educate people about the importance of tax revenues; (4) modify our priorities for government spending; (5) make the Code more equitable, from both a vertical and horizontal perspective; (6) distinguish more clearly between choate and inchoate violations; (7) rethink the requirements of mens rea; and (8) increase enforcement and make the level of enforcement more uniform.

<sup>163</sup> Id. at 226-31.

<sup>164</sup> Id. at 232:

<sup>165</sup> Id.

He suggests three traditional moral frameworks for tax noncompliance: (1) the prohibition against stealing; (2) the general obligation to obey the law; and (3) the prohibition against cheating. <sup>166</sup> Green argues that stealing does not provide an appropriate framework because taxpayers usually do not directly get something for nothing when they fail to comply with the tax laws (except in the context of avoiding certain permitting fees). <sup>167</sup> In addition, the moral obligation to obey the law does not provide an effective framework because it leads too easily to a potential rationalization for disobeying the law on the grounds that the law is unjust. <sup>168</sup> Accordingly, Green argues that the most appropriate moral framework is to conceptualize tax noncompliance as a form of cheating. <sup>169</sup>

<sup>166</sup> Id.

<sup>167</sup> Id. at 233. Note that the CATECHISM OF THE CATHOLIC CHURCH, however, would support this view of tax noncompliance. CATECHISM OF THE CATHOLIC CHURCH ¶ 2409 (2d ed. 1997). See infra note 182 and surrounding text for a fuller discussion of the CATECHISM OF THE CATHOLIC CHURCH's treatment of tax evasion. Interestingly, Green does not cite to the Catechism in discussing the view that tax evasion is akin to theft (although he does cite to it for the view that tax evasion violates the obligation to obey authority). See note 182. He does, however, cite to REV. MARTIN T. CROWE, C.SS.R., S.T.L., THE MORAL OBLIGATION OF PAYING JUST TAXES: A DISSERTATION 42 (The Catholic University of America Press Washington, D.C. 1944), for the proposition that tax evasion is theft. As will be discussed infra in this part, this likely represents a simplification of Crowe's views on the subject. See notes181–185 and surrounding text.

Green, supra note 25, at 234-235. Note that Green does point out that the CATECHISM OF THE CATHOLIC CHURCH does consider tax compliance to be part of the duty to obey the law. Id. at 234 (citing CATECHISM OF THE CATHOLIC CHURCH, supra note 167, ¶ 2240). See note 182 and surrounding text for a fuller discussion of the Catechism of the Catholic Church's treatment of tax evasion.

Green, supra note 25, at 235 (although he does note that the cheating framework still carries some rationalization concerns).

Susan Pace Hamill also believes that a moral evaluation of tax policy is essential to determine sound tax policy. <sup>170</sup> Hamill argues that a moral evaluation of tax policy is the only valid metric that can be used to choose among competing tax regimes because the economic models that have been used to evaluate tax policy are fatally flawed through their use of limited variables. <sup>171</sup> She takes this argument one

The three main moral systems Hamill discusses are utilitarianism, egoism, and virtue ethics. *Id.* at 879–80. Hamill argues that utilitarianism is not a helpful moral system for tax policy decisions because, in order to make utilitarian decisions, policy makers would need more reliable economic information to know fully which system of taxation would benefit the largest number of people economically. *Id.* at 880. Egoism and virtue ethics are useful moral systems because, while they reach different conclusions (egoists concluding that a flat tax is superior and virtue ethicists advocating for a progressive tax system), these conclusions would remain the same regardless of what economic information is available. *Id.* at 883–88.

Susan Pace Hamill, An Evaluation of Federal Tax Policy Based on Judeo-Christian Ethics, 25 VA. TAX REV. 671, 671-764 (2006) [hereinafter Hamill, Federal Tax Policy Based on Judeo-Christian Ethics]. See also Susan Pace Hamill, A Moral Perspective on "Big Business" Fair Share of America's Tax Burden, 1 U. St. Thomas L. J. 857, 857-908 (2004) [hereinafter Hamill, A Moral Perspective

Hamill, A Moral Perspective, supra note 170, at 879. Hamill argues that incorrect policy decisions occur when policy makers try to pick a tax system by relying on economic models such as the model for marginal utility and the models used to support supply side economics. Id. at 879–83. According to Hamill, the marginal utility model is often used to oppose progressive taxation, but it can only be used for that because of its weaknesses—namely that it cannot "measure both the amount of sacrifice associated with the loss of one dollar from a person earning a specific income level and how that level of sacrifice relates to the appropriate tax burden." Id. at 872. In addition, Hamill argues that economic simulation models are useless in predicting the effects of a tax system because they cannot handle multiple variables and because they do not adequately consider personal factors. Id. at 878. Furthermore, Hamill maintains that the economic simulation models do not adequately account for variables that go into predicting economic growth. Id.

step further, however, by describing what a tax system based on Judeo-Christian ethics would look like.<sup>172</sup>

Hamill argues that Judeo-Christian ethical principles "require tax policy structures that both raise adequate revenues providing all citizens a reasonable opportunity to reach their potential, and allocate the burden for paying the taxes under a moderately progressive model." While Hamill does not believe that Judeo-Christian ethics support a heavily redistributist theory of taxation, the does believe that Judeo-Christian principles would not support a tax policy in which only a minimalist state is funded. Hamill concludes that a valid Judeo-Christian tax policy must strike a balance between respecting individual property rights and providing everyone with a chance to realize their potential. Hamill does not believe that this balance can be achieved with a flat tax (and certainly not with a

For these reasons, Judeo-Christian teachings condemn as immoral legal structures, which includes tax policy, that involve a massive wholesale redistribution of wealth *see*king equality of result along the lines of a socialist or communist regime or a welfare state. Moreover, unlike certain less extreme but still liberal-leaning moral frameworks defining justice, the Judeo-Christian standard of justice requiring reasonable opportunity does not even call for a generous level of tax revenues that attempts to achieve real equal opportunity in a numeric sense of measuring resources.

Hamill, Federal Tax Policy Based on Judeo-Christian Ethics, supra note 170; Hamill, A Moral Perspective, supra note 170.

<sup>&</sup>lt;sup>173</sup> Hamill, Federal Tax Policy Based on Judeo-Christian Ethics, supra note170, at 679.

<sup>174</sup> Id. at 692:

<sup>175</sup> Id. at 693. Hamill believes that this minimalist approach to tax policy is driven by a concept of objectivist ethics in which people want minimal taxes and a minimal state. Id. at 743-47. She argues that this ethical system is really a form of atheism because it elevates the individual to an almost god-like status. Id. at 743.

<sup>176</sup> Id. at 748.

regressive tax), and some measure of progressivity would be required, which would require legitimate sacrifice from a naturally resistant wealthy class.<sup>177</sup>

Catholic scholars have also begun to discuss tax policy as a moral issue. Michael Livingston argues that Catholic principles of solidarity and the preferential option for the poor have provided a framework for Catholic scholars to support a progressive tax system and "[to express] one's commitment to the broader society without sacrificing the right to private property."178 While the Catholic hierarchy in the United States has supported progressive tax policy and has stated that tax policy should be evaluated in terms of its effect on the poor, the bishops have surprisingly not used extensive moral language to evaluate tax policy, possibly because the Church has not "develop[ed] a more sophisticated theory of private wealth and how wealth creation and distribution should be balanced consistently with Catholic teaching . . . . "179 Pope Benedict XVI's most recent encyclical, Caritas in Veritate, however, focuses primarily on economic issues, indicating that the Catholic Church might be in the process of developing a more nuanced theory that would lead to greater analysis of tax issues in a moral context. 180

<sup>177</sup> Id. at 709-10. This resistance from the wealthy is easy to understand: "Second, and arguably of greater importance, those enjoying higher levels of income and wealth are far more vulnerable to succumbing to the sin of greed and therefore will tend to fight for the smallest tax burden possible without considering the moral obligations demanded of their faith." Id. at 710.

Michael A. Livingston, The Preferential Option, Solidarity, and the Virtue of Paying Taxes: Reflections on the Catholic Vision of a Just Tax System 7 (Jan. 4, 2007) (unpublished paper available at http://ssrn.com/abstract=958806, Rutgers-Camden School of Law). Livingston argues that these principles have provided a mechanism to evaluate tax policy through a third option that rejects the extremes of both Marxism and capitalism. *Id*.

<sup>179</sup> Id. at 12.

Caritas in Veritate, supra note 158, ¶ 37 (noting that "every economic decision

If tax policy is evaluated in moral terms, then tax compliance should be as well. Judeo Christian scholars have wrestled with each other as to whether there is a moral obligation to comply with the tax laws, and, if there is, what the extent of that obligation is. <sup>181</sup> The Catholic theologian Martin Crowe has provided the most extensive review in the United States of these competing ideas in light of the Catholic intellectual tradition. <sup>182</sup> Crowe concludes that there is a moral obligation to pay just taxes, although the basis of this moral obligation most likely arises from legal justice and from piety, <sup>183</sup> rather

has a moral consequence"). Indeed, the Pope mentions tax policy directly in his encyclical, and indicates that moral tax policy might involve what he describes as "fiscal subsidiarity":

One possible approach to development aid would be to apply effectively what is known as fiscal subsidiarity, allowing citizens to decide how to allocate a portion of the taxes they pay to the State. Provided it does not degenerate into the promotion of special interests, this can help to stimulate forms of welfare solidarity from below, with obvious benefits in the area of solidarity for development as well.

Id. at ¶ 60.

- <sup>181</sup> See CROWE, supra note 167.
- 182 Id. Note that the CATECHISM OF THE CATHOLIC CHURCH has at least indicated a moral obligation to pay taxes, although the obligation is mentioned only in passing without the considerable analysis of the underlying moral basis for the obligation described by Crowe. CATECHISM OF THE CATHOLIC CHURCH, supra note 167, ¶ 2409 (listing tax evasion as one of the ways an individual can violate the Seventh Commandment's prohibition on theft); Catechism of the Catholic Church section 2240 (establishing that paying taxes is morally obligatory as part of a taxpayer's obligation to submit to lawful authority). See also Green, supra note 25, at 234–35 (discussing CATECHISM OF THE CATHOLIC CHURCH, supra note 167, ¶ 2240 as part of his analysis of whether tax evasion is a breach of the duty to obey the law)
- 183 Crowe, supra note 167, at 151-63. Note that Crowe considers legal justice to be the same as social justice. *Id.* at 145-46. Note also that "piety", as used by Crowe, does not possess the meaning that a reader might ascribe to it—rather it

than from commutative justice (although Crowe acknowledges that he cannot rule out the commutative justice theory in its entirety). <sup>184</sup> Regardless of whether the obligation arises from commutative justice or legal justice and piety, the obligation remains even after the noncompliance has occurred (i.e., a taxpayer is not discharged from his obligation of paying an intentionally evaded tax simply by seeking forgiveness). <sup>185</sup> Some Jewish scholars have considered this obligation to be even more absolute and have argued that tax evasion is rarely, if ever, ethical, even if the imposed taxes are unjust. <sup>186</sup>

That scholars have begun moral and, more specifically, religious analysis of tax policy and compliance suggests that these norms could be harnessed in an effort to change the prevailing tax compliance culture. Accordingly, the government should consider entering into various partnerships with Judeo-Christian religious organizations in order to effect this change. In order to be worthwhile, however, such

refers to rendering something to the state or another individual on account of it being the state or other individual's due. *Id.* at 162.

<sup>&</sup>lt;sup>184</sup> *Id.* at 151, 158–60. Commutative justice is the theory of justice that directs an individual's relations with other individuals. *Id.* at 114.

<sup>185</sup> If the obligation is based on commutative justice, then there would be an obligation to make restitution for any intentional noncompliance. *Id.* at 160, n.224. If the obligation arises in legal justice or piety, "the obligation remains as long as the law imposing the obligation of paying taxes is effective . . " *Id.* Note that the commutative justice theory provides the more lasting obligation, however, because the obligation under legal justice would presumably last only as long as the applicable statute of limitations, while the obligation under commutative justice would potentially have no such limitation.

MCGEE, supra note 12 at 45-53 (summarizing Jewish thought regarding the obligation to pay taxes); see also Kenneth H. Ryesky, A Jewish Ethical Perspective to American Taxation, 10 RUTGERS J. L. & RELIG.8 (2009). Contrast this view with that expressed by Crowe: "any individual who would certainly be taxed more than his just share, would be excused from complying with the law." CROWE, supra note 167 at 26; see also MCGEE, supra note 12 at Ch. 6.

partnerships must have a strong possibility of influencing taxpayer norms and must provide incentives for taxpayers and religious organizations to participate without requiring a significant expenditure of government resources during implementation.

### C. The Key Characteristics of Government Partnerships with Religious Organizations

While providing very specific details about how such partnerships could be structured is beyond the scope of this article, there are three key traits that should characterize these partnerships in order to provide the greatest possibility of success. These traits are: (1) that the religious organizations serve as effective forums for taxpayer education; (2) that the religious organizations serve as an intermediary between taxpayers and the government; and (3) that both the government and the religious organizations are incentivized to enter into the partnerships.

# 1. Religious Organizations as Forums for Taxpayer Education

The first characteristic of a successful partnership would be that the partnership provides a new and effective forum for taxpayer education. Educational campaigns designed both to demonstrate the societal consequences of not paying taxes and to educate taxpayers about the relevant procedural and technical details of the tax system can help cultivate the idea that individuals should comply with the tax laws if they do not wish to create harmful consequences for those around them.<sup>187</sup> To be convincing, however, the source of the

<sup>187</sup> See Babcock, Assuming Personal Responsibility,, supra note 26, at 165-67 (demonstrating how these types of educational programs can be effective in helping to change environmental norms. Although not addressing tax compliance directly, changing environmental norms involves many of the same

educational efforts must be trustworthy and reliable.<sup>188</sup> As discussed in Part III.D., *supra*, the government alone often is not considered to be trustworthy or reliable. Religious organizations can legitimize government information through their role as a moral authority within a community.<sup>189</sup>

The IRS could inquire whether the religious organizations would be willing to provide forums through which the IRS could provide educational programs to taxpayers. These programs could have a two-pronged approach: (1) illustrating exactly what tax expenditures are used for and why these expenditures are important to the public good; and (2) providing in person technical assistance to taxpayers who might not otherwise seek out technical advice through the other forums that the IRS makes available. The government would not need to invest considerable resources into such programs because the educational materials would only need to be created once and then just periodically updated, and the frequency of the presentations could be limited to account for IRS personnel availability. In addition, the

challenges inherent in attempts to change tax compliance norms); Johnson, *supra* note 144, at 161–62 (proposing partnerships between the government and religious organizations to provide information to encourage environmental compliance); Kornhauser, *A Tax Morale Approach*, *supra* note 35, at 629–30 (suggesting a variety of educational programs that she believes would be effective in changing compliance norms).

- <sup>188</sup> Babcock, Assuming Personal Responsibility, supra note 26, at 170.
- <sup>189</sup> See discussion of Kahan, Community Policing supra note 40, in note 129 and surrounding text.
- <sup>190</sup> But see infra Part IV.D.4 for a discussion of how these educational efforts might backfire if not tailored carefully.
- The programs could simply be offered a few times a year, which would possibly give them an even greater chance of success because taxpayers would not get fatigued through constant presentations. The fact that this initiative would not involve a considerable resource outlay is not indicative that it would not be effective. In fact, some of the most effective norm changing strategies involve

IRS would benefit from built in efficiencies inherent in religious organizations' abilities to conduct effective information campaigns as well as religious organizations' ability to spread a message to a wide range of socio-economic groups. 192

Although the IRS could neither ask that religious leaders specifically preach about tax related issues nor incorporate religious themes into its educational materials for constitutional reasons, <sup>193</sup> ideally, religious leaders would organically do this in order to strengthen the effectiveness of the educational programs. <sup>194</sup> Indeed, some scholars have forcefully argued that religious leaders have a moral obligation to speak publicly about tax in moral terms:

Finally, religious leaders have the greatest moral obligations to preach and teach the true word of God even if the wealthiest and most powerful members of the community do not want to hear the message. In their preaching and teaching, religious leaders must apply faith based moral principles to all issues of the day, including tax policy. Those leading congregations with wealthy and politically powerful members have the greatest moral obligations to

very simple efforts that simply insure that the right messenger is spreading the right type of message to the right audience that will spread that message. Gladwell, *supra* note 152, at 255.

<sup>192</sup> Johnson, supra note 144, at 148 (religious organizations "already have many of the experts that are necessary to design, implement, and evaluate effective information campaigns."); Gladwell, supra note 152, (describing the importance of "Connectors" to spread new ideas to vast numbers of different people).

<sup>&</sup>lt;sup>193</sup> Indeed, there are legitimate constitutional concerns with any type of government partnership with a religious organization. These will be discussed more fully in infra Part IV.D.

There is precedent for religious organizations taking such an initiative because they have already done so in regards to environmental compliance, another area in which the government has sought to change individual behavior. Johnson, *supra* note 144, at 150-61.

challenge these individuals to overcome the sin of greed and meet their enhanced moral obligations to support tax policy consistent with Judeo-Christian teachings. 195

Considering there is support for the argument that there is a moral obligation to comply with the tax laws in the Judeo-Christian tradition, such preaching could emphasize this obligation. This emphasis could be critical in helping shape the attitudes of religious taxpayers, many of whom have likely not considered that tax compliance is a moral as well as a legal obligation. In addition, if religious leaders answered this call, this could indirectly lend even more moral authority to the simultaneous government information campaigns being presented to taxpayers at the site of the religious organizations.

### 2. Religious Organizations as Intermediaries

A second (and, albeit, more controversial) component of an effective partnership between the government and religious organizations could involve the religious organizations as intermediaries between taxpayers and the government. As taxpayers become more conscious of the moral obligation of complying with the tax laws, they will recognize a need to remedy past noncompliance (both intentional and inadvertent). For example, as discussed *supra*, in addressing the moral obligation inherent in tax compliance, Catholic scholars mostly recognize that there is a continuing moral obligation to pay a just tax even after that tax has already been evaded. 196

Hamill, Federal Tax Policy Based on Judeo Christian Ethics, supra note 170, at 706–07; see also Ryesky, supra note 186 ("Religious leaders in the Jewish community need to make clear that tax fraud is inimical to Jewish laws and values and is unacceptable in the Jewish community.").

 $<sup>^{196}</sup>$  See discussion of Crowe, supra note 167, in notes 181-185 and surrounding text.

Depending on whether this obligation is based on a theory of restitution or if it is based on a theory of legal justice, it could extend indefinitely or simply until the statute of limitations expires. <sup>197</sup> A problem arises, however, in that the parishioner might not satisfy this continuing obligation based on a fear of civil or criminal penalties that could be imposed.

The government already has several mechanisms in place through which taxpayers can remedy past errors, such as the amended return process, the "conscience fund", and the IRS's voluntary disclosure practice. The problem with these mechanisms is that they are either not anonymous (a problem with amended returns) or that they do not provide a guaranty that civil or criminal penalties will not be imposed if they are applicable. While there are strong arguments against providing blanket immunity to taxpayers who decide to come clean after being intentionally noncompliant, both the government and taxpayers could benefit by a mechanism through

<sup>197</sup> See discussion of Crowe supra note 167, in notes 181-185 and surrounding text.

See notes 67-70 and surrounding text for a discussion of amended returns. The "conscience fund" is an account into which the government deposits checks from taxpayers who remit payment, often anonymously, with an indication that it is to make reparations for past wrongdoings. I.R.S. Internal Revenue Manual § 3.8.45.7.35; see also Brendan Miniter, To Uncle Sam With Love: Taxes Too Low? The Treasury is Happy to Take Your Money, WALL St. J., Apr. 15, 2002. An overview of the IRS's voluntary disclosure practice is available at IRM § 9.5.11.9.

<sup>199</sup> See Boris Bittker and Lawrence Lokken, Federal Income Taxation of Income, Estates, and Gifts ¶ 113.1 ("Belated payments by repentant taxpayers to the Treasury's so-called conscience fund, however, are treated not as tax payments but as gifts to the United States and are used to reduce the national debt."). Note, however, that, even though taxpayers are not fully protected by payments to the conscience fund, "Treasury officials, welcoming such demonstrations of tardy rectitude and eager to encourage more to come clean, do not identify or try to punish any of these givers." Warren Weaver, Jr., Washington Talk; 'Conscience Fund' at New High, N.Y. Times, March 18, 1987.

religious organizations could serve as an intermediary between the taxpayers and the government for purposes of securing an "immunity option".

This immunity option could be secured as follows: a taxpayer feeling remorseful for past noncompliance could inform a religious organization that he would like to remedy the past noncompliance. The religious organization could then provide anonymous information to the IRS about the nature of the tax noncompliance along with a check for the amount that is believed to be owed (the taxpayer would reimburse the religious organization for the funds). The IRS could then choose to accept or reject the funds based on the information it has learned about the noncompliance. If the IRS accepted the check, it would be estopped from imposing civil or criminal penalties against the taxpayer in question for the transaction as long as the information provided was accurate (after the IRS has agreed to the deal, the taxpayer's anonymity shield could be removed). If the IRS rejected it, the IRS would still not know the taxpayer's identity, although if the IRS caught the taxpayer in its normal course, there would be no protection provided.<sup>200</sup>

Although such a program would use specific religious organizations as the intermediaries, it would have to be available to the public at large (as opposed to only being available to members of the particular religious organization) in order to mitigate the constitutional concerns (which, as will be discussed *infra*, can likely be successfully addressed).<sup>201</sup> Such broad availability of this program naturally leads to a question of what the advantage is for using the religious organizations as the relevant intermediaries. There is still an

<sup>&</sup>lt;sup>200</sup> Whether this immunity option could be provided with a mere change in agency policy or whether it would require actual congressional authority is beyond the scope of this article, although the answer to this question is important in determining the practical feasibility of such a proposal.

<sup>&</sup>lt;sup>201</sup> See discussion in Part IV.D.1.

advantage to using the religious organizations because the religious organizations' involvement lends more moral authority to the program and helps the program contribute to actual norm changing behavior. <sup>202</sup> In addition, although the program would be open to the public at large, it would certainly attract the attention of those who are inclined to accept tax compliance as a religious and moral issue. Accordingly, the government would feel more confident that it is providing this beneficial treatment to taxpayers who are not seeking to game the system (although some gaming is still inevitable) but rather to those taxpayers who are actively changing their attitudes to become more compliant. Thus, in addition to encouraging norm changing, the program would have the beneficial effects described by the scholars who argue for a more targeted form of tax enforcement. <sup>203</sup>

# 3. Incentives for the Government and Religious Organizations to Enter Into the Partnerships

The third element critical to a successful partnership is a set of incentives to encourage religious organizations and taxpayers to participate. The intermediary program described *supra* provides considerable incentives for the government to participate because of the potential for increased revenue from remorseful taxpayers and because of the potential for a positive norm shift to occur. But what do religious organizations get from the relationship? As Tracey Meares has observed, the success of community policing programs in which local governments partnered with religious organizations was due in part to the fact that the religious organizations received greater access to government resources.<sup>204</sup>

<sup>202</sup> Of course, once the norm is successfully changed, such an intermediary program might no longer be necessary.

<sup>203</sup> See discussion in Part III.B.2.

<sup>&</sup>lt;sup>204</sup> Meares, *supra* note 148, at 1339.

Because religious organizations are already tax exempt, there is not much in the way of actual tax breaks that could be used as an incentive. What could be valuable to the organizations. however, is greater access to government information about their own compliance obligations. For example, the IRS has determined that approximately seventy-five percent of § 501(c)(3) organizations have violated the prohibition against political campaigning, and that many of these violations occur because the organization is ignorant of the prohibition's scope.<sup>205</sup> Such ignorance based errors could be avoided if the organizations had an easy mechanism by which to learn about the prohibition's scope and about their other compliance requirements. By engaging in partnerships with the government, religious organizations could help establish this relationship by developing a strong, cooperative working relationship with the government that could allow for much easier resolution of compliance questions for the religious organizations themselves.

### D. Potential Problems with Government Partnerships with Religious Organizations

Although partnerships between the government and religious organizations offer potential for significant advantages to both the government and the religious organizations, a number of potential roadblocks need to be considered. These range from whether such partnerships are constitutional to whether the potential benefits would actually materialize in light of practical implementation concerns. These concerns are real and cannot be completely dismissed. Nevertheless, none of these obstacles create such a large roadblock that these partnerships should not be attempted.

<sup>&</sup>lt;sup>205</sup> Gina M. Lavarda, Nonprofits: Are You At Risk of Losing Your Tax Exempt Status?, 94 IOWA L. REV. 1473, 1476-77 (2009).

#### 1. The Constitutional Problem

When dealing with a potential partnership between the government and religious organizations, the first concern inevitably is the constitutional question. Tracey L. Meares and Kelsi Brown Corkran acknowledge that there are certainly constitutional concerns when the government partners with a religious organization.<sup>206</sup> Nevertheless, they believe that these concerns could be assuaged if the Supreme Court formally adopted a standard for evaluating Establishment Clause cases that they believe has at least been implicit in the Court's Establishment Clause jurisprudence under the Lemon<sup>207</sup> test. Meares and Corkran argue that, while the *Lemon* test is phrased very formalistically,<sup>208</sup> they believe that the Supreme Court implicitly adopts more of a balancing test, although decisions are usually phrased in formalistic terms to fit the stated Lemon test.<sup>209</sup> Under this balancing test, the extent of the state's entanglement with religion would be balanced against the competing state interest for the entanglement in order to see whether such entanglement might be permissible under the Constitution.<sup>210</sup> If this balancing approach is indeed already occurring, making it explicit makes sense. Such an approach could lead to a nuanced constitutional analysis of whether the types of partnerships discussed supra could be justifiable as

<sup>&</sup>lt;sup>206</sup> Meares, *supra* note 148, at 1362

<sup>&</sup>lt;sup>207</sup> Id. at 1379; Lemon v. Kurtzman, 403 U.S. 602 (1971).

<sup>&</sup>lt;sup>208</sup> Meares and Corkran describe the *Lemon* test as "a three-pronged test for permissible statutory law under the Establishment Clause: the statute must have a secular purpose, its primary effect must not be the advancement or inhibition of religion and it must not foster excessive government entanglement with religion." Meares, *supra* note 148, at 1366.

<sup>&</sup>lt;sup>209</sup> Id.

<sup>&</sup>lt;sup>210</sup> Id.

furthering an important state interest with harmless entanglement of the government with religious organizations.

Even if the partnerships are constitutional, they could still create the very type of problem that violates the spirit of the Constitution, if not its letter. Dan Kahan points out that these types of partnerships likely are technically constitutional but nevertheless create a risk of creating sectarian conflict, which is exactly the type of conflict that the Establishment Clause was designed to prevent. These problems could be ameliorated, however, if religious organizations ended up forming stronger connections with each other by participating in a program that they recognized was benefitting the entire community. Placeholder of the participating in a program that they recognized was benefitting the

#### 2. The Excitement Problem

Another problem that could impact the partnerships' effectiveness is the fact that religious organizations and the public at large do not viscerally connect to tax compliance on an intuitive moral level. As Michael Livingston observes, "proclamations regarding tax policy rarely carry the emotion of (say) declarations on abortion, human rights, or the alleviation of hunger." As anyone who has had to admit at a dinner party that they work in the tax field can attest, the excitement problem is a real one. This lack of an emotional connection on a moral level can perhaps in part be explained by the fact that discussions of taxation issues often ignore moral and equitable issues in favor of an efficiency analysis under the belief that the equity issues are too abstract to effectively inform the

<sup>&</sup>lt;sup>211</sup> Kahan, Community Policing, supra note 40, at 1534–35

<sup>&</sup>lt;sup>212</sup> See Meares, supra note 148.

<sup>&</sup>lt;sup>213</sup> Livingston, *supra* note 178, at 11.

discussion.<sup>214</sup> Because of the potential for a modern "republican moment" in tax compliance,<sup>215</sup> the time could be ripe for the public to recognize the importance of maintaining the treasury as a moral issue, thus providing a rare opportunity to overcome the public's typically unenthusiastic attitude towards tax compliance.

### 3. The Hypocrisy Problem

A third potential problem is that one of the assumptions critical to the partnerships' success, namely, religious organizations possessing inherent moral authority, could be undermined by hypocritical behavior from both taxpayers, claiming to be adherents to religious principles, and by inconsistent behavior from the organizations themselves. Despite the high percentage of Americans identifying as a member of a Judeo-Christian religious group, <sup>216</sup> a significant percentage of individuals who identify as members of these denominations openly disagree with some of the group's moral teachings. <sup>217</sup> For example, when Catholics are polled about whether abortion and stem cell research should be legal, 61% of non-weekly Mass attendees believe that they should be legal, and even 30% of weekly Mass attendees share this belief. <sup>218</sup> Accordingly, expecting that religious taxpayers will automatically start viewing tax compliance as a moral imperative solely because they receive a mandate from a

<sup>&</sup>lt;sup>214</sup> See Christians, supra note 155 (arguing that these moral and equitable issues should in fact play a large role in analysis of tax policy).

<sup>&</sup>lt;sup>215</sup> See discussion of Babcock in notes 134-141 and surrounding text.

<sup>&</sup>lt;sup>216</sup> See note 12.

<sup>217</sup> See Pew Research Center, Catholics, Obama and Notre Dame, Views of Abortion and Stem Cell Research Poll at http://pewresearch.org/pubs/1213/catholicsobama-notre-dame-commencement.

<sup>218</sup> Id..

religious organization is naïve. Nevertheless, given the tax gap's vast size, significant revenue gains can be achieved even with a small percentage improvement in the overall compliance rate. Thus, the fact that only a small percentage of noncompliant taxpayers<sup>219</sup> might change their behavior does not mean that the program should not be adopted.

The organizations themselves could also undermine their authority through hypocritical behavior of their own. Matthew J. Barrett has illustrated how this inconsistency can arise in the Catholic Church.<sup>220</sup> After conducting a survey of actual practices within the internal diocesan tax structures of the Catholic Church in the United States, Barrett discovered that only 20% of reporting dioceses use a progressive system of taxation.<sup>221</sup> The other dioceses employ more of a flat tax system with mild progressivity achieved through mechanisms such as standard deductions.<sup>222</sup>

If religious organizations are not viewed to be employing the type of tax system that they claim is required for a just society, then the value of relying on their inherent moral authority to lend credence to the types of educational programs discussed *supra* diminishes, if not disappears. Although this potential inconsistency could lessen the effectiveness of the proposed partnerships, the partnerships could end

For example, this percentage could be the percentage of taxpayers who might not currently consider tax compliance to be a moral issue but who would be prone to changing their views if the message was presented in a religious context. While the size of this group is unclear, such a group most likely exists.

Matthew J. Barrett, The Theological Case for Progressive Taxation as Applied to Diocesan Taxes or Assessments Under Canon Law in the United States, 63 THE JURIST 312, 314 (2003).

Id. Note that such a regressive, flat tax, diocesan tax system cannot be defended on the grounds that Canon law mandates such a system because, according to Barrett, no such mandate exists. See Id.

<sup>&</sup>lt;sup>222</sup> Id.

up being a triggering event that actually causes improvement with the internal tax systems of the religious organizations. Using the Catholic diocesan tax system as an example, the partnerships could provide a good opportunity for the Catholic bishops to engage in a dialogue with the laity about what constitutes a just tax system and why there is a moral obligation to adopt such a system and to comply with it. In addition to the benefits of such a dialogue in helping create a new norm of tax compliance, this dialogue could lead to the Church adopting an internal tax system that is also more reflective of Catholic social teaching on taxation. Accordingly, rather than the hypocrisy problem limiting the success of the partnerships, the partnerships could actually help address the inconsistency itself, thus providing a further benefit to the religious organizations from entering into the partnerships.

#### 4. The Just Tax Problem

Another potential problem is that, inevitably, religious taxpayers (or any taxpayers for that matter) will not agree with everything the government does with tax revenues. If taxpayers discover that significant funds are being spent on policies that the taxpayers believe violate their moral convictions, they might come to believe that the taxes being imposed are in fact unjust and thus not morally obligatory.<sup>224</sup> While this cannot be completely eliminated, it can be ameliorated by illustrating how significant tax expenditures are directed towards public goods that are generally in agreement with

See Barrett, supra note 220 (noting that, while the Bishops possess final authority on the type of diocesan tax system to be used, they could benefit from a discussion with the laity as to what such a system should look like if it is to reflect Catholic social teaching).

<sup>&</sup>lt;sup>224</sup> See note 186 for a discussion of how religious scholars have debated over whether the obligation to comply with the tax laws is dependent on them being just.

religious convictions. In addition, much like how the hypocrisy problem could have benefits, taxpayers who begin asking these questions could open a dialogue with the government on tax policy. This discussion could lead to a more robust debate over what moral tax policy should be and how public funds should be spent, thus more directly inserting morality into the tax and public finance debate.

#### CONCLUSION

Due to the complexity of the tax gap's underlying causes, no one solution can hope to eliminate the bulk of noncompliance.<sup>225</sup> The most effective solutions, however, will be those that achieve a long term change in tax compliance and that do not require a massive increase in the use of limited IRS resources. The proposed partnerships between the government and religious organizations provide an opportunity for such a solution. Religious organizations provide an ideal forum for

Id.

See Joshua D. Rosenberg, Narrowing the Tax Gap: Behavioral Options, 117 TAX NOTES 517 (2007). In endorsing many of the solutions discussed in this article, such as increased information reporting, use of third party enforcement, and public campaigns to influence behavior, Rosenberg concludes that these types of proposals must be used in tandem to have the achieve the greatest compliance results:

While dramatic changes in behavior are not likely to occur without changes in cognitive, emotional and perceptual frames, and while behavior change itself will often help bring about accompanying changes in cognitive, emotional and perceptual frames, behavior change is often directly accomplished most often by a combination of (1) modeling, (2) stimulus control, and (3) response control. Essentially, modeling is simply showing people how to do something, stimulus control refers to establishing an environment that is conducive to the desired behavior, and response control refers to a system that rewards desired behaviors and punishes undesired behaviors so as to shape peoples' reactions in a favorable way.

linking a large number of taxpayers to the government because of their established information distribution networks and because of their ability to lend moral authority to the obligation to understand and comply with the tax laws. Implementing such a program would require patience, however, because the relevant norm is not likely to change overnight. Nevertheless, taxpayers will change their attitudes in the long run only if they come to conceptualize tax policy and tax compliance as a moral issue much in the same way that citizens have come to view the environment as a moral issue. The government faces an uphill battle to try to change these attitudes by itself. Working together, however, religious organizations and the government can help trigger this shift in taxpayer attitudes and can take a large step towards closing the tax gap once and for all.

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# Home is Where the HQ is: Corporate Citizenship Following the Supreme Court's Decision in *Hertz Corp. v. Friend*

ABSTRACT. On February 23, 2010, the United States Supreme Court released its decision in the case of Hertz Corp. v. Friend, 559 U.S. \_\_\_ (2010), no. 08-1107 ("Hertz"). The Hertz case represents the only time the Supreme Court has addressed the question of where a business's "principal place of business" is located for purposes of determining diversity jurisdiction. The Court's ruling is certain to have significant ramifications for American corporations, as it determines when corporations can remove cases to federal court (as they might prefer), or in plaintiff-friendly state courts. As the most authoritative case discussing diversity jurisdiction for corporations today, Hertz is likely to find its way into Civil Procedure and Corporate law textbooks as early as this Summer/Fall 2010. This article summarizes and analyzes the reasoning of the Supreme Court's opinion and the practical implications arising from the Court's holding.

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HOME IS WHERE THE HQ IS: CORPORATE CITIZENSHIP FOLLOWING THE SUPREME COURT'S DECISION IN HERTZ CORP. V. FRIEND

#### INTRODUCTION

When a large, multi-state corporation is sued in state court, the defendant's counsel's first question is often whether there are grounds to remove the case to federal court. Federal courts, deservedly or not, are often seen as more "desirable" forums for corporate defendants. However, removal requires establishment of federal question or diversity jurisdiction.

For purposes of diversity jurisdiction, a corporation is deemed to be a citizen of the state of its incorporation as well as the state where it has its "principal place of business." The proper understanding and interpretation of this phrase was at the heart of the Supreme Court of the United State's recent decision in *Hertz Corp. v. Friend.* This article provides a history of the phrase and discusses the substance and implications of the Court's opinion.

#### I. DIVERSITY JURISDICTION

The federal courts are courts of limited jurisdiction. Article III of the United States Constitution restricts federal jurisdiction to claims based on a federal question and claims that satisfy diversity jurisdiction.<sup>3</sup>

<sup>&</sup>lt;sup>1</sup> 28 U.S.C. § 1332(c)(1).

<sup>&</sup>lt;sup>2</sup> 559 U.S. \_\_\_\_ (2010), No. 08-1107.

<sup>3</sup> See U.S. Const. art. III, § 2 ("The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution... [and] to Controversies... between Citizens of different States."); 28 U.S.C. § 1331 (2006) (granting federal district courts original jurisdiction over all controversies that raise a question of constitutional or federal law); see also id. § 1332 (granting federal district courts original jurisdiction over cases where the amount in controversy exceeds \$75,000 and is between citizens of different states).

The Supreme Court has interpreted the latter narrowly, requiring complete diversity and a minimum amount-in-controversy.<sup>4</sup>

Federal jurisdiction is restricted to limit the volume of cases that federal courts hear and to protect the right of state courts to determine questions of state law. An additional concern over potential home-state bias, however, influenced the constitutional framers to allow diversity actions to be heard in federal court regardless of subject matter. While jurists and legal commentators debate whether such bias still exists today, diversity jurisdiction remains "to shore up confidence in the judicial system by preventing even the appearance of discrimination in favor of local residents." 5

Before 1958, the statute defining federal diversity requirements stated that a corporation was a citizen of its state of incorporation only. In practice, this led to instances where local businesses could avoid state courts simply by filing charters in other states. As a result, federal courts were often burdened with diversity cases involving state law claims and counter-parties that were not truly "foreign." In an effort designed, in part, to reduce frauds and abuses on the courts, Congress added subsection (c) to Section 1332 in 1958 to provide that "a corporation shall be deemed a citizen of any State by which it has been incorporated and of the State where it has its principal place of business." (Emphasis added.) Congress purposefully chose to allow multiple citizenships for a corporation — utilizing the conjunctive "and" in listing both the place of incorporation and

<sup>&</sup>lt;sup>4</sup> Strawbridge v. Curtiss, 7 U.S. 267, 267 (1806) (announcing a complete diversity rule); see also Ruhrgas v. Marathon Oil Co., 526 U.S. 574, 580 n.2 (1999) (interpreting § 1332 to require complete diversity even though the Constitution permits federal courts to hear cases between citizens of different states).

John H. Beisner & Jessica Davidson Miller, They're Making a Federal Case Out of It... In State Court, 25 Harv. J.L. & Pub. Pol'y 143, 146 (2001) (citing Class Action Fairness Act of 1999: Hearing Before the Subcomm. on Admin. Oversight and the Courts of S. Comm. on the Judiciary, 106th Cong. 100 (1999) (statement of Prof. E. Donald Elliot, Yale Law School).

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principal place of business. Allowing for additional states of citizenship is in tune with the original purposes of the statute — to limit the number of cases being removed to federal court, thus limiting access to federal forum whenever there is a colorable basis to do so.

#### II. THE CASE OF HERTZ CORP. V. FRIEND

### A. Factual and Procedural History

In 2007, Melinda Friend and John Nhieu filed a putative class action in California state court against nationwide rental company The Hertz Corporation ("Hertz"), alleging that Hertz had violated California wage and hour laws. The proposed class was wholly comprised of California citizens. Hertz was incorporated in Delaware and has an established corporate headquarters in Park Ridge, New Jersey. Hertz therefore removed the case on the basis of diversity jurisdiction. Plaintiffs moved for remand, arguing a lack of diversity because all parties were California citizens. With no federal question at issue, federal jurisdiction turned on whether California should be considered Hertz's "principal place of business."

Hertz is a national company, conducting business in 44 states. At the time of removal, California was home to 20.5% of Hertz's employees, 17% of Hertz's physical rental locations and facilities, and was the source of 18.6% of Hertz's revenues.<sup>6</sup> Plaintiffs cited these statistics to argue California was Hertz's principal place of business, relying primarily on the Ninth Circuit's holding in *Tosco Corp. v. Communities for a Better Environment*. <sup>7</sup>

In *Tosco*, the Ninth Circuit recognized two tests for determining a corporation's principal place of business. First, the "place of

The next closest state, Florida, was home to 14.3% of Hertz's employees, 9.7% of Hertz's property, and was where 11.6% of Hertz's revenues were generated.

<sup>&</sup>lt;sup>7</sup> 236 F. 3d 495 (9th Cir. 2001) (per curiam).

operations" test focused on the state where a "substantial predominance of corporate operations" occurred. To determine whether a corporation's operations "substantially predominate" in a given state, *Tosco* instructed lower courts to compare a corporation's business activity in the state at issue to its activity in other states, taking into account "the location of employees, tangible property, production activities, sources of income, and where sales take place." Second, the "nerve center" test identifies the principal place of business as the state "where the majority of [the corporation's] executive and administrative functions are performed. Rather than restricting analysis to one test over the other, the Ninth Circuit established a hierarchy between the tests, directing that the "nerve center" test should only be used when no state contains a "substantial predominance of the corporation's business activities."

Here, Plaintiffs argued that since more of Hertz's employees, tangible property, and revenues could be found in California than in any other state, California was where a "substantial predominance" of Hertz's business activities took place and, therefore, was Hertz's "principal place of business" for the purposes of § 1332(c)(1). Plaintiffs further argued that Hertz, a well-known, national company, was not "the kind of litigant that diversity jurisdiction was intended to protect," and that companies that have as large of a business presence within California, as Hertz does, are unlikely to be treated as outsiders or suffer local bias in state court. 11

<sup>8</sup> Tosco, 236 F. 3d 495, 497, 500-02.

<sup>&</sup>lt;sup>9</sup> Id. at 500.

<sup>10</sup> Id.

Plaintiff's Memorandum in Support of Motion to Remand at 3, No. 3:07-cv-05222 (N.D. Cal. Nov. 9, 2007) (quoting Ghaderi v. United Airlines, Inc., 136 F. Supp. 2d 1041, 1043 (N.D. Cal. 2001).

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In opposition, Hertz argued that the scope of its California business was merely reflective of the state's size, and not a result of any deliberate attempt to concentrate its activities in California. Hertz also argued that, in the big picture, its business operations were not "substantially predominant" in California, or any other state; further, even though California was the location of more employees and rental locations, in absolute terms, that number is not disproportionately high when examined on a per capita basis. Hertz relied on Ho v. Ikon Office Solutions, Inc. 12 to support its position that a forum state's large size can have a distorting effect on statistics regarding a company's multi-state business activities. Specifically, Hertz emphasized the impropriety of the "place of operations" test in that its application would necessarily result in many national corporations being deemed California citizens based solely on the state's size and population. This, Hertz argued, was both unfair and contrary to the underlying purposes of diversity jurisdiction. In addition, relying on pre-Tosco precedent, Hertz argued that the "nerve center" test was the more appropriate analysis for a corporate party as operationally diverse as Hertz.<sup>13</sup>

In granting Plaintiffs' Motion to Remand, the District Court noted that "a plurality" of each of Hertz's *Tosco*-relevant business activities were in California. Specifically, the district court compared Hertz's employee head count, property ownership and revenue, in absolute terms, between California and the state where Hertz had its next-largest presence, Florida. Applying this analysis, the district court held California was Hertz's "principal place of business."

<sup>12 143</sup> F. Supp. 2d 1163 (N.D. Cal. 2001).

Defendant's Brief in Opposition to Plaintiff's Motion to Remand at 4, 3:07-cv-05222 (N.D. Cal. Nov. 9, 2007).

Order Granting Plaintiffs' Motion to Remand; Vacating Hearing at 4, No. 3:07-cv-05222-MMC (N.D.Cal. Jan. 15, 2008).

Hertz appealed, but the Ninth Circuit, in a short, unpublished opinion, affirmed.<sup>15</sup> The Ninth Circuit found that the district court had correctly applied the "place of operations" test and that Hertz's relevant business activities were "significantly larger" in California than in any other state.<sup>16</sup> Like the district court, the Ninth Circuit refused to consider "the comparative population of states in which a corporation operates to determine whether activities are significantly larger in one state than another."<sup>17</sup> Finally, the court also noted that Hertz's extensive California contacts relieved it of any danger of being mistreated in a California state court.

### B. The Circuit Split

In its petition for a writ of certiorari, Hertz demonstrated the presence of "a deep four-way split" among the Circuit Courts of Appeal regarding the various tests for determining a corporation's "principal place of business." As discussed, the Ninth Circuit applied the "place of operations" test, in the first instance, with the "nerve center" test as a fallback. Alternatively, the Seventh Circuit relied solely on the "nerve center" test, directing courts to identify "the corporation's brain," which is most often found "where the corporation has its headquarters." Similar to the Seventh Circuit's test, the Third

<sup>15</sup> See Friend v. Hertz Corp., 297 F. App'x 690, 2008 WL 4750198 (9th Cir. 2008)

<sup>&</sup>lt;sup>16</sup> Friend, 297 F. App'x at 691.

<sup>17</sup> Id.

Petition for Writ of Certiorari at 2, Hertz Corp. v. Friend, 559 U.S. \_\_\_\_ (2010) (No. 08-1107), 2008 U.S. Briefs 1007 at \*2, 2009 U.S. S. Ct. Briefs LEXIS 1633.

Wisconsin Knife Works v. National Metal Crafters, 781 F. 2d 1280, 1282 (7th Cir. 1986); Metropolitan Life Ins. Co. v. Estate of Cammon, 929 F.2d 1220, 1223 (7th Cir. 1991) ("this court follows the 'nerve center' approach to corporate citizenship: a corporation has a single principal place of business where its executive headquarters are located."). In Wisconsin Knife, the Seventh Circuit

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Circuit's "center of corporate activities" test focused on a corporation's "headquarters of day-to-day corporate activity and management." <sup>20</sup> Finally, the "total activities" or "totality of circumstances" test, adopted by the Fifth, Sixth, Eight, Tenth and Eleventh Circuits, sought a broader examination of the corporation and its business, considering a list of factors, including: the corporation's nerve center, the locations of its business operations, as well as the totality of surrounding circumstances, including the character and purposes of the corporation, and the kind of business in which it is engaged. <sup>21</sup> The remaining circuits — the First, Second, and Fourth — have applied some or all of the tests described above without formally adopting any one of them; however, these Circuits' approaches have most closely resembled the multi-factor approach of the "total activities" test.

### C. The United States Supreme Court's Hertz Decision

In light of the circuit split, the Supreme Court granted Hertz's petition for writ of *certiorari*, and on February 23, 2010, issued its written decision. Justice Breyer, writing for a unanimous Court, directed that the phrase "principal place of business" referred to "the

openly acknowledged that other courts use "vaguer" standards and look to other factors besides a corporation's headquarters to determine where the "principal place of business" is located, but believing that diversity jurisdiction "ought to be readily determinable," it deliberately chose to go with the "simpler" nerve center test, and refused to consider factors such as location of employees, tangible property or sales in its determination. 781 F. 2d 1280, 1282

- 20 Kelly v. U.S. Steel Corp., 284 F. 2d 850, 854 (3d Cir. 1960). Unlike the "nerve center" test, however, the Third Circuit also considered the location of the corporation's plants and employees, though the Court acknowledged that these considerations are "elements of lesser importance." *Id.*; see also Mennen Co. v. Atlantic Mut. Ins. Co., 147 F. 3d 287, 291 (3d Cir. 1998).
- See, e.g., Gafford v. General Elec. Co., 997 F. 2d 150, 161 (6th Cir. 1993); Amoco Rocmount Co. v. Anschutz Corp., 7 F.3d 909, 915 (10th Cir. 1993).

place where the corporation's high level officers direct, control, and coordinate the corporation's activities," otherwise known as the corporation's "nerve center . . . [which] will typically be found at a corporation's headquarters." The Court placed "primary weight" upon "the need for judicial administration of a jurisdictional statute to remain as simple as possible." 23

The Court began by tracing the development of corporations as legal parties — following them from non-entities to artificial persons to full-fledged corporate citizens. As with any statutory analysis, the Court began its inquiry with the plain language of the statute, noting that "principal place of business" was adopted rather than a citizenship test based on "gross income" because it was a "simpler and more practical formula." The Court acknowledged that this language was not as simple to apply as the drafters had intended. Rather, the Circuits had divided in their approaches, with some courts adopting the multi-factor "business activities" tests that are fundamentally "at war with administrative simplicity." Finding these complex tests "unusually difficult to apply" and in some cases "imprecise[ly]" articulated, the Court noted that it is unsurprising that "different circuits (and sometimes different courts within a single circuit) have applied these highly general multifactor tests in different ways." 27

Despite diversity jurisdiction's origins in protecting against party-bias by local courts, the Court gave little weight to this argument. The Court observed that less quantifiable factors such as a

 $<sup>^{22}</sup>$   $\,$  Hertz. 559 U.S. \_\_\_\_ (2010), No. 08-1107, slip op. at 1.

<sup>23</sup> Id.

<sup>&</sup>lt;sup>24</sup> *Id.* at 8.

Id. at 9 (quoting Hearings on H.R. 2516 et al. before Subcommittee No. 3 of the House Committee on the Judiciary, 85th Cong., 1st Sess., 37 (1957)).

<sup>&</sup>lt;sup>26</sup> Hertz, 559 U.S. \_\_\_\_ (2010), No. 08-1107, slip op. at 13.

<sup>&</sup>lt;sup>27</sup> *Id.* at 11.

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corporation's image, history, and advertising can more often influence prejudice against an out-of-state party than factors such as plant location, or sales and employment statistics, which "sometimes bear no more than a distant relation to the likelihood of prejudice." <sup>28</sup>

In holding that a corporation's "nerve center" is its jurisdictional "principal place of business," the Court emphasized three considerations. First, under the plain language of the statute, the word "place" in 28 U.S.C. 1332(c)(1) indicates a singular, "main, prominent or leading" location.<sup>29</sup> The Court read this as the corporate headquarters, finding "the 'place' is a place within a State. It is not the State itself."<sup>30</sup> Second, jurisdictional statutes demand rules that are easy to administer and promote judicial efficiency. Finding that multifactor "business activities" tests were often complicated, unnecessarily costly and timely to litigate, and encouraged gamesmanship among litigants, the Court favored the "nerve center" test.<sup>31</sup> Third, the Court found the "nerve center" test best met the goals of simpler administration and predictability of outcomes that both Congress and the Court favor.<sup>32</sup>

Cognizant of the impact a jurisdictional decision may have on a case, the Court recognized the potential for abuse under the "nerve center" test. Thus, the Court instructed the lower courts to scrutinize those litigants who may seek to create "sham" headquarters solely for jurisdictional purposes. Emphasizing practical substance over mere formality, the Court directed that a company's "principal place of business" is the place from which it actually directs and manages its business, regardless of where the corporation indicates it is

<sup>28</sup> Id. at 13.

<sup>&</sup>lt;sup>29</sup> Id. at 14.

<sup>30</sup> Id.

<sup>&</sup>lt;sup>31</sup> *Id.* at 15-16.

<sup>32</sup> *Id.* at 16.17.

headquartered. Since the burden of persuasion for establishing diversity jurisdiction remains on the party asserting it, that corporation must have "competent proof" to support jurisdiction.<sup>33</sup> Such proof must be more than a designation on its public agency or tax filings nor can a location qualify if it solely serves as the location for board meetings or corporate retreats.<sup>34</sup> For jurisdictional purposes, a corporation's headquarters is the place from which the actual direction, control or coordination of the corporation emanates.

The Court acknowledged the bright-line "nerve center" test is imperfect, and that "anomalies will arise." 35 For example, the Court described a hypothetical where "the bulk of a company's business activities" took place in New Jersey, but "its top officers direct those activities just across the river in New York."36 Despite the inconsistency with the goals upon which diversity jurisdiction was created, the Court acknowledged that New York would be this hypothetical company's "principal place of business" and any claim against it in New Jersey could be removed to federal court.<sup>37</sup> Further, the Court acknowledged that the influence of modern communications technology and/or decentralized management structures could also create seemingly unplanned results. However, the Court determined that "[a]ccepting occasionally counterintuitive results is the price the legal system must pay to avoid overly complex jurisdictional administration while producing the benefits that accompany a more uniform legal system."38 No test is perfect, certainly, but in the

<sup>&</sup>lt;sup>33</sup> *Id.* at 18.

<sup>&</sup>lt;sup>34</sup> *Id*.

<sup>35</sup> *Id.* at 17.

<sup>&</sup>lt;sup>36</sup> *Id*.

<sup>37</sup> Id..

<sup>&</sup>lt;sup>38</sup> Id. at 18.

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majority of instances, the "nerve center" test effectively "points courts in a single direction, towards the center of overall direction, control and coordination."<sup>39</sup>

### III. PRACTICAL IMPLICATIONS OF THE HERTZ DECISION

For corporate citizens, and the attorneys who defend them, the *Hertz* decision provides clarity to what was once a murky area of the law. In addition to "administrative simplicity" for the courts, the "nerve center" test makes predictions regarding a company's citizenship more reliable. Provided that a company has an established headquarters from which its management exerts practical control over its operations, the company can be reasonably confident it will be a citizen of that state.

For corporations without an established headquarters, they could be well-served by establishing one. Establishment of a corporate headquarters allows a corporation to preemptively forum shop—in the most legitimate, non-nefarious meaning of the term—for a desirable jurisdiction. Even those corporations with a decentralized management structure should consider the advantages of establishing a headquarters in anticipation of future litigation. So long as corporations can be "haled into court" in jurisdictions within which they have minimum contacts, corporate-defendants cannot often choose, in the first instance, the forum within which a plaintiff may elect to sue them; however, the *Hertz* opinion grants companies the ability to establish citizenship and obtain a clearer picture of where more of those suits may arise as well as the ability to predict where such suits may be removed.

<sup>&</sup>lt;sup>39</sup> *Id.* at 17.

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### CONCLUSION

The United States Supreme Court's holding in *Hertz* established the "nerve center" test for determining a corporation's "principal place of business" and, thus, its citizenship, for purposes of diversity jurisdiction under 28 U.S.C. §1332(c)(1). The Court found the "nerve center" test to be the most administratively simple to apply, for most cases, while providing the least potential for incongruous results. The Court's ruling in *Hertz* provides welcomed guidance to litigants faced with diversity jurisdiction disputes and will benefit judicial economy overall.

HOME IS WHERE THE HQ IS: CORPORATE CITIZENSHIP FOLLOWING THE SUPREME COURT'S DECISION IN  $HERTZ\ CORP.\ V.\ FRIEND$ 

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Π.

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# State Homestead Exemptions and Bankruptcy Law: Is it Time for Congress to Close the Loophole?

ABSTRACT. When the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was signed into law on April 20, 2005, states retained the ability to opt out of the federal exemptions and provide their own state citizens with greater or lesser protection than that available under federal bankruptcy law with regard to personal and real property exempted from attachment in bankruptcy cases. Thus, BAPCPA tacitly continues the practice of allowing both debtors and creditors in different states to be afforded very different protections with regard to debtors' rights to exempt property from attachment and creditors' rights to have debts satisfied from a bankrupt debtor's estate. This paper will focus on the specific exemptions allowed Chapter 7 filers in the various U.S. jurisdictions and explore the issues of fairness that remain in a federal law that is decidedly not uniform throughout the United States.

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#### INTRODUCTION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA" or "the Act") was signed into law on April 20, 2005 and became fully effective on October 17, 2005.1 The stated purpose of the Act was "to improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair for both debtors and creditors."2 With respect to the rights of creditors, the Act was intended to bring about reforms to address "many of the factors contributing to the increase in consumer bankruptcy filings, such as lack of personal financial accountability, the proliferation of serial filings, and the absence of effective oversight to eliminate abuse in the system. . . . [and] to ensure that debtors repay creditors the maximum they can afford."3 For all of the significant and controversial changes imposed by the Act, Congress left in place the ability of states to opt out of the federal exemptions and provide their own state citizens with greater or lesser protection than that available under federal bankruptcy law with regard to personal and real property exempted from attachment in bankruptcy cases. Thus, the Act tacitly continues the practice of allowing both debtors and creditors in different states to be afforded very different protections with regard to debtors' rights to exempt property from attachment and creditors' rights to have debts satisfied from a bankrupt debtor's estate.

<sup>&</sup>lt;sup>1</sup> Pub. L. No. 109-8, 119 Stat. 23 (2005).

<sup>&</sup>lt;sup>2</sup> H.R. Rep. No. 109-31, pt. 1, at 2 (2005), reprinted in 2005 U.S.C.C.A.C. 88, 89.

<sup>3</sup> Id.

## I. PROPERTY EXEMPT FROM ATTACHMENT UNDER THE BANKRUPTCY CODE

The U.S. Bankruptcy Code<sup>4</sup> allows a debtor who files for Chapter 7 protection to exempt a modest amount of personal property and a limited amount of the equity in his/her primary home from inclusion in the debtor's estate, thereby allowing a bankrupt debtor to retain some of his or her property after a bankruptcy judgment. The amount of these exemptions is rather modest under federal law. Under § 522 (d) of the Bankruptcy Code, the following property may be exempt by a debtor as of this writing:

- · Up to \$20,200 of the value in real or "personal property that the debtor. . . uses as a residence", or of "a burial plot" (the homestead exemption);<sup>5</sup>
- · The debtor's interest in a motor vehicle up to \$3,225;6
- The debtor's interest up to \$525 per item with a maximum aggregate value of \$10,775 in household goods, "wearing apparel", appliances, books, animals, crops, or musical instruments primarily for "personal, family or household use of the debtor" or his/her dependents;7

<sup>4 11</sup> U.S.C. § 522

<sup>&</sup>lt;sup>5</sup> 11 U.S.C. § 522 (d) (1).

<sup>6 11</sup> U.S.C. § 522 (d) (2).

<sup>&</sup>lt;sup>7</sup> 11 U.S.C. § 522 (d) (3).

- The "debtor's aggregate interest" in jewelry used for "personal, family or household use of the debtor" or his/her dependents up to \$1,350;8
- The debtor's interest in any other property up to \$1,075 in value "plus up to \$10,125 of any unused "homestead exemption; 9
- The aggregate interest up to \$2,025 in "professional books" and tools of the trade of the debtor or his/her dependents;<sup>10</sup>
- · The interest in "any unmatured life insurance contract owned by the debtor" (other than "credit life insurance" contracts)<sup>11</sup>
- The aggregate value of up to \$10,775 in accrued dividends or interest in an unmatured life insurance contract owned by the debtor insuring the life of the debtor or of a dependent;<sup>12</sup>
- · Health aids of the debtor or his/her dependents;13

<sup>8 11</sup> U.S.C. § 522 (d) (4).

<sup>9 11</sup> U.S.C. § 522 (d) (5).

<sup>10 11</sup> U.S.C. § 522 (d) (6).

<sup>11 11</sup> U.S.C. § 522 (d) (7).

<sup>&</sup>lt;sup>12</sup> 11 U.S.C. § 522 (d) (8).

<sup>13 11</sup> U.S.C. § 522 (d) (9).

• "The debtor's right to receive...social security benefits, unemployment compensation, or local public assistance benefits"; a disability, illness or unemployment benefit; "alimony, support and separate maintenance" agreements to the extent these are reasonably necessary to support the debtor or his/her dependents; payments under stock bonus, profit sharing, "annuity or similar plan on account of illness", disability, death, age or length of service "to the extent these are reasonably necessary to support the debtor or his/her dependents; the debtor's right to receive property for victim's reparation", life insurance contract payments for an individual of whom debtor was a dependent, up to \$20,200 for a personal injury recovery not including pain and suffering or compensation for actual pecuniary loss of the debtor or a dependent; and retirement funds that are tax exempt under the Internal Revenue Code. 14

#### II. THE HOMESTEAD EXEMPTION IN THE STATES

Reasonable people may differ as to whether the provisions for personal and homestead exemptions just cited are sufficiently generous to permit debtors whose debts are discharged under Chapter 7 of the bankruptcy Code to retain sufficient resources to have the opportunity for fresh start on life. To be sure, a one-size-fits-all strategy can have a disproportionate impact on bankruptcies in states with higher than normal cost of living and property values. Congress could certainly address this issue by tying the federal homestead and personal exemptions to cost of living, average income, property values or some other objective formula that would ensure the same relative treatment to all citizens in Chapter 7 liquidation proceedings regardless of their

<sup>&</sup>lt;sup>14</sup> 11 U.S.C. §§ 522 (d) (10)-(12).

state of residence. Instead, Congress opted in the 1978 Bankruptcy Code to permit states to opt out of the federal exemptions and provide their citizens with either greater or lesser protection than that afforded by the Code. Thus states are free to decide the limits of the exemptions that they provide for their citizens. And most have done so, applying remarkably different standards that result in vastly different protection being afforded to bankruptcy filers depending on their state of residence. While some differences exist with regard to the personal property exemptions allowed by states that have "opted out" of the federal exemptions, it is the homestead exemption where the differences are most striking, as Table 1 illustrates.

Table 1: Maximum Homestead Exemption Amount Available by Jurisdiction

Homestead Exemption by Jurisdiction			
State	Maximum Exemption (in Dollars)	Notes	
Alabama	$5,000^{16}$	None.	
Alaska	54,00017	Property owned by the entirety or in common that is used by one or more individual owners or their dependents as their principal residence entitles each owner to a maximum homestead exemption of \$54,000. The aggregate value of	

<sup>&</sup>lt;sup>15</sup> 11 U.S.C. § 522 (b) (3) (A).

<sup>&</sup>lt;sup>16</sup> Ala. Code § 6-10-2 (2008).

<sup>&</sup>lt;sup>17</sup> Alaska Stat. § 09.38.010 (2008).

		multiple homestead exemptions
		allowable with respect to a single
		living unit may not exceed \$
		54,000. If there are multiple
		owners of property exempt as a
		homestead, the value of the
		exemption of each individual
		owner may not exceed the
		individual owner's pro rata
	_	portion of \$54,000.18
Arizona	$150,000^{19}$	A homestead exemption is
		available to any person over the
		age of 18 regardless of marital
		status <sup>20</sup> and includes mobile home
		residences <sup>21</sup> and the land in
		which a mobile home is located. <sup>22</sup>
		Only one exemption is allowed for
		married couples. <sup>23</sup>
Arkansas	Unlimited <sup>24</sup>	The homestead exemption is
		unlimited for homesteads
		occupied by married individuals
		or heads of household provided

<sup>&</sup>lt;sup>18</sup> Alaska Stat. § 09.38.010(b) (2008).

<sup>&</sup>lt;sup>19</sup> Ariz. Rev. Stat. § 33-1101 (2008).

<sup>&</sup>lt;sup>20</sup> Ariz. Rev. Stat. § 33-1101(a) (2008).

<sup>&</sup>lt;sup>21</sup> Ariz. Rev. Stat. § 33-1101(a)(3) (2008).

<sup>&</sup>lt;sup>22</sup> Ariz. Rev. Stat. § 33-1101(a)(4) (2008).

<sup>&</sup>lt;sup>23</sup> Ariz. Rev. Stat. § 33-1101(c) (2008).

<sup>&</sup>lt;sup>24</sup> Ark. Code. Ann. § 16-66-210 (2008).

		the land is not more than 80 acres
		in rural areas $^{25}$ and $\frac{1}{4}$ acre in
		cities, towns or villages <sup>26</sup> .
		Homesteads larger than 80 acres
		but not larger than 160 acres in
		rural areas are limited to a \$2,500
	İ	exemption <sup>27</sup> and in cities the
		homestead exemption for
		homesteads larger than ¼ acre
		but not more than 1 acre is
		likewise limited to \$2,500.28
California	50,00029	The homestead exemption
		increases to \$75,000 if the
		judgment debtor or spouse of the
	· ·	judgment debtor who resides in
		the homestead is at the time of
		the attempted sale of the
		homestead a member of a family
		unit, and there is at least one
		member of the family unit who
		owns no interest in the homestead
		or whose only interest in the
		homestead is a community
		property interest with the
		judgment debtor. 30 The exemption

<sup>&</sup>lt;sup>25</sup> Ark. Code. Ann. § 16-66-210(c)(1) (2008).

<sup>&</sup>lt;sup>26</sup> Ark. Code. Ann. § 16-66-210(c)(2) (2008).

<sup>&</sup>lt;sup>27</sup> Ark. Code. Ann. § 16-66-210(c)(1) (2008).

<sup>&</sup>lt;sup>28</sup> Ark. Code. Ann. § 16-66-210(c)(2) (2008).

<sup>&</sup>lt;sup>29</sup> Cal. Civ. Proc. Code § 704.730 (2007).

<sup>&</sup>lt;sup>30</sup> Cal. Civ. Proc. Code § 704.730(a)(2) (2007).

		increases to \$150,000 if the
		judgment debtor or spouse of the
		judgment debtor who resides in
		the homestead is at the time of
		the attempted sale of the
		homestead is 65 years of age or
		older, <sup>31</sup> suffers from a mental or
		physical disability that prevents
		them from engaging in
		substantial gainful employment <sup>32</sup>
		or is 55 years of age with an
		income of not more than \$15,000
		if single and \$20,000 if married
		and the sale is an involuntary
		sale.33 If both spouses are entitled
		to a homestead, the exemption
	•	amount is apportioned between
1.		the spouses on the basis of their
		proportionate interests in the
		homestead and cannot exceed the
		total noted maximum amounts in
		the aggregate. <sup>34</sup>
Colorado	60,00035	The homestead exemption is
	-	raised to \$90,000 if the owner, the
		owner's spouse or a dependent of
		the owner is 60 years of age or

<sup>31</sup> Cal. Civ. Proc. Code § 704.730(a)(3)(A) (2007).

<sup>32</sup> Cal. Civ Proc § 704.730(a)(3)(B) (2007).

<sup>&</sup>lt;sup>33</sup> Cal. Civ. Proc. Code § 704.730(a)(3)(C) (2007).

<sup>34</sup> Cal. Civ. Proc. Code § 704.730(b) (2007).

<sup>35</sup> Colo. Rev. Stat. § 38-41-201 (2007).

		older or suffers from a disability that impairs their ability to engage in a useful occupation. <sup>36</sup>
Connecticut	75,00037	If the money judgment against the debtor arises out of services provided at a hospital, then the amount of the exemption is \$125,000. <sup>38</sup>
Delaware	50,00039	In the case of joint debtors who can claim the same homestead exemption, the aggregate amount cannot exceed in total \$50,000.40
District of Columbia	Unlimited <sup>41</sup>	None.
Florida	Unlimited <sup>42</sup>	None.
Georgia	10,000 <sup>43</sup>	Where property is owned by two spouses one of whom is a debtor, the homestead exemption is \$20,000.44
Hawaii	$20,000^{45}$	The exemption is \$30,000 for an

 $<sup>^{36}</sup>$   $\,$  See Colo. Rev. Stat. §§ 38-41-201(1)(b), (2)(a)-(b) (2007).

<sup>37</sup> Conn. Gen. Stat. § 52-352b (2008).

<sup>38</sup> Conn. Gen. Stat. § 52-352b(t) (2008).

<sup>&</sup>lt;sup>39</sup> Del. Code. Ann. Tit. 10 § 4914 (2008).

<sup>40</sup> Del. Code. Ann. Tit. 10 § 4914(d) (2008).

<sup>41</sup> D.C. Code § 15-501 (2008).

<sup>&</sup>lt;sup>42</sup> Fla. Stat. § 222.05 (2008).

<sup>43</sup> Ga. Code Ann. § 44-13-100(a)(1) (2008).

<sup>44</sup> Id.

<sup>45</sup> Haw. Rev. Stat. § 651-92(a)(2) (2008)

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		individual who is the head of a family of an individual 65 years of age or older. 46 The statute does not require that the real estate be a homestead; rather, it exempts from attachment an interest in "one parcel of real property in the state." 47
Idaho	100,00048	Mobile homes are included in the homestead exemption whether or not they are permanently affixed to land. <sup>49</sup>
Illinois	15,00050	If two or more individuals own property that is exempt as a homestead, the value of the exemption of each individual may not exceed his or her proportionate share of \$ 30,000 based upon percentage of ownership. <sup>51</sup> The homestead exemption includes not only real estate, but also "personal property, owned or rightly possessed by lease or otherwise

<sup>&</sup>lt;sup>46</sup> Haw. Rev. Stat. § 651-92(a)(1) (2008).

<sup>47</sup> Haw. Rev. Stat. § 651-92(a)(1),(2) (2008).

<sup>&</sup>lt;sup>48</sup> Idaho Code Ann. § 55·1003 (2008).

<sup>&</sup>lt;sup>49</sup> Idaho Code Ann. § 55-1001(ii) (2008).

<sup>&</sup>lt;sup>50</sup> 735 Ill. Comp. State. 5/12-901 (2008).

<sup>&</sup>lt;sup>51</sup> *Id*.

		and occupied by him or her as a residence "52
Indiana	$15,000^{53}$	The exemption is available
		individually to joint debtors who
		own property as tenants by the
		entirety. <sup>54</sup> Thus husbands and
		wives who are joint debtors are
		each entitled to a \$15,000
		exemption.
Iowa	Unlimited <sup>55</sup>	None.
Kansas	Unlimited <sup>56</sup>	The homestead must not exceed
		"one hundred and sixty acres of
		farming land, or of one acre
		within the limits of an
		incorporated town or city, [and
		must be] occupied as a residence
		by the family of the owner."57
Kentucky	$5,000^{58}$	The exemption applies to real
		estate or personal property used
		as a permanent Residence (or a
		burial plot) but is inapplicable if
		the debt or liability existed prior

<sup>&</sup>lt;sup>52</sup> *Id*.

<sup>&</sup>lt;sup>53</sup> Ind. Code Ann. § 34-55-10-2 (2008).

<sup>&</sup>lt;sup>54</sup> *Id*.

<sup>&</sup>lt;sup>55</sup> Iowa Code § 561.16 (2008).

<sup>&</sup>lt;sup>56</sup> Kan. Stat. Ann. 15, § 9 (2006).

<sup>&</sup>lt;sup>57</sup> *Id*.

<sup>&</sup>lt;sup>58</sup> Ky. Rev. Stat. Ann. § 427.060 (West 2008).

	<del></del>	
		to the purchase of or erection of
		improvements to the property. <sup>59</sup>
Louisiana	$25,000^{60}$	The homestead cannot be larger
		than 200 acres if outside of a
		municipality or five acres if
	·	within it.61 For obligations arising
		out of catastrophic or terminal
		illness or injury illness, the
		homestead exemption will be the
		full value of the home. <sup>62</sup> A
		catastrophic illness or injury is
		defined as "an illness or injury
		which creates uninsured
		obligations to health care
	ľ	providers of more than ten
		thousand dollars and which are
		greater than fifty percent of the
		annual adjusted gross income of
		the debtor, as established by an
		average of federal income tax
		returns for the three preceding
		years."63
Massachusetts	500,00064	Where the property is owned by
		more than one owner, including

<sup>&</sup>lt;sup>59</sup> *Id.* 

<sup>60</sup> La. Rev. Stat. Ann. 20:1 (2008).

<sup>61</sup> La. Rev. Stat. Ann. 20:1(a)(1) (2008).

<sup>62</sup> La. Rev. Stat. Ann. 20:1(a)(2) (2008).

<sup>63</sup> La. Rev. Stat. Ann. 20:1(a)(3) (2008).

<sup>64</sup> Mass. Gen. Laws ch. 188, § 1 (2008).

Maine	35,00066	tenants by the entirety, "only one owner may acquire an estate of homestead in any such home for the benefit of his family; and provided further, that an estate of homestead may be acquired on only one principal residence for the benefit of a family."65  If a minor dependent of the debtor has the principal residence with the debtor, the exemption is raised to \$70,000.67 The limit is also raised to \$70,000 if the debtor is 60 or older or suffers from a physical or mental disability.68
Maryland	5,00069	None.
Michigan	30,000 <sup>70</sup>	The exemption is \$45,000 for persons 65 years of age or older. <sup>71</sup>
Minnesota	300,000 <sup>72</sup>	The exemption is limited to a homestead not to exceed 160 acres and is limited to \$300,000

<sup>65</sup> Id.

<sup>66</sup> Me. Rev. Stat. Tit. 14 § 4422(1) (2008).

<sup>67</sup> Me. Rev. Stat. Tit. 14. § 4422(1)(a) (2008).

<sup>68</sup> Me. Rev. Stat. Tit. 14 § 4422(1)(b).

<sup>69</sup> Md. Code Ann., Cts & Jud. Proc. § 11-504(f) (2008).

<sup>70</sup> Mich. Comp. Laws. § 600.5451(n) (2008).

<sup>71</sup> *Id.* 

<sup>&</sup>lt;sup>72</sup> Minn. Stat. § 510.02 (2007).

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		whether it is claimed by one or more joint owners. <sup>73</sup> For homesteads used for agricultural purposes, the exemption is \$750,000. <sup>74</sup>
Missouri	15,000 <sup>75</sup>	If a homestead is owned by more than one person, the total amount of the homestead exemption that can be claimed is \$15,000 in the aggregate. <sup>76</sup>
Mississippi	75,00077	The homestead cannot exceed 160 acres. <sup>78</sup>
Montana	250,000 <sup>79</sup>	Where property is jointly owned, each owner may claim a percentage Of the homestead equal to the percentage of their undivided interest in the property. <sup>80</sup>
Nebraska	60,00081	The land may not exceed 160 acres in any unincorporated city

<sup>&</sup>lt;sup>73</sup> *Id*.

<sup>&</sup>lt;sup>74</sup> *Id*.

<sup>&</sup>lt;sup>75</sup> Mo. Rev. Stat. § 513.475(1) (2008).

<sup>76</sup> *Id* 

<sup>77</sup> Miss. Code Ann. § 85-3-21 (2008).

<sup>&</sup>lt;sup>78</sup> *Id*.

<sup>&</sup>lt;sup>79</sup> Mont. Code Ann., § 70-32-104(1) (2007).

<sup>80</sup> Mont. Code Ann., § 70-32-104(2) (2007).

<sup>81</sup> Neb. Rev. Stat. § 40-101 (2008).

		or village or two lots within any incorporated city or village.82
Nevada	550,00083	If alloidal title has been
		established and not relinquished,
		the exemption extends to the
		entire equity in the homestead
		regardless of amount.84
New Hampshire	$100,000^{85}$	None.
New Jersey	None <sup>86</sup>	New Jersey makes no provision
		for a homestead exemption, but
		the federal homestead exemption
		of \$20,200 <sup>87</sup> is available in a
		bankruptcy proceeding.
New Mexico	60,00088	If there are two joint owners, each
		is entitled to a \$60,000
		exemption.89
New York	$50,000^{90}$	None.
North Carolina	$18,500^{91}$	Unmarried debtors of the age of
		65 or older may claim a

<sup>82</sup> Id.

<sup>83</sup> Nev. Rev. Stat. § 115.010(2) (2007).

<sup>84</sup> Id.

<sup>85</sup> N.H. Rev. Stat. Ann. § 480:1 (2008).

<sup>86</sup> N.J. Stat. Ann. § 2A:17·17 (2008).

<sup>87 11</sup> U.S.C. § 522(d)(1).

<sup>88</sup> N.M. Stat. § 42-10-9 (2008).

<sup>89</sup> Id.

<sup>90</sup> N.Y. C.P.L.R. Law § 5206(1)(a) (McKinney 2008).

<sup>91</sup> N.C. Gen. Stat. § 1C-1601(a)(1) (2008).

		homestead exemption of
		\$37,000.92
North Dakota	$80,000^{93}$	None
Ohio	5,00094	In the case of a judgment or order regarding money owed for health care services or health care
		supplies provided to the debtor or a dependent of the debtor, one parcel or item of real or personal
·		property that the debtor or a
		dependent of the debtor uses as a
		residence is exempt from
		execution, garnishment,
		attachment or sale regardless of
		value. But a judgment lien can be
		placed on such property that can
		be enforced when the property is
		sold or otherwise transferred by
		the judgment debtor other than to
		his/her surviving spouse or
		surviving minor children. <sup>95</sup> In
		such cases, the judgment debtor's
		interest in the homestead
		property up to \$5,000 is not
		subject to attachment.96

<sup>&</sup>lt;sup>92</sup> *Id.* 

<sup>93</sup> N.D. Cent. Code § 47-18-01 (2008).

<sup>&</sup>lt;sup>94</sup> Ohio Rev. Code Ann. § 2329.66(a)(1)(b) (West 2008).

<sup>95</sup> Ohio Rev. Code Ann. § 2329.66(a)(1)(a) (West 2008).

<sup>&</sup>lt;sup>96</sup> *Id*.

Oklahoma	Unlimited <sup>97</sup>	None.
Oregon	30,00098	"When two or more members of a
		household are debtors whose
		interests in the homestead are
		subject to sale on execution, the
		lien of a judgment or liability in
		any form, their combined
		exemptions under this section
		shall not exceed \$ 39,600."99
Pennsylvania	$None^{100}$	Pennsylvania makes no provision
		for a homestead exemption in
		state law. Pennsylvania law does
		not preclude bankruptcy filers
		from choosing the federal
		exemptions, in lieu of the state
		personal property exemptions.
		Thus, the \$20,200 <sup>101</sup> federal
		homestead exemption is available
		as an option to bankruptcy filers
		who opt to use the federal
		exemptions.
Puerto Rico	15,000102	None.
Rhode Island	$300,000^{103}$	Only one owner of the property

<sup>97</sup> Okla. Stat. Tit. 31 § 1 (2008).

<sup>98</sup> Or. Rev. Stat. § 18.395(1) (2007).

<sup>&</sup>lt;sup>99</sup> Id.

<sup>100 42</sup> Pa. Cons. Stat. § 8124 (2007).

<sup>&</sup>lt;sup>101</sup> 11 U.S.C. § 522(d)(1).

<sup>&</sup>lt;sup>102</sup> P.R. Laws Ann. Tit. 31 § 1851 (2006).

<sup>&</sup>lt;sup>103</sup> R.I. Gen. Laws § 9-26-4.1(a) (2008).

South Carolina	50,000106	may claim the homestead exemption for a family. 104 A family is defined as "a parent and child or children, a husband and wife and their children, if any, or a sole owner. 105 Multiple homestead exemptions are allowable to co-owners of a single homestead up to a maximum aggregate value of \$100,000.107 Where there are multiple owners of homestead property, the exemption of each owner cannot exceed their fractional portion of \$100,000.108
South Dakota	Unlimited <sup>109</sup>	None.
Tennessee	$5,000^{110}$	Joint owners of property are
		entitled to an aggregate
		exemption not to exceed \$7,500 to
		be divided equally among them. 111
Texas	Unlimited <sup>112</sup>	The homestead if outside of a

<sup>&</sup>lt;sup>104</sup> R.I. Gen. Laws § 9-26-4.1(b) (2008).

<sup>&</sup>lt;sup>105</sup> *Id.* 

<sup>&</sup>lt;sup>106</sup> S.C. Code Ann. § 15-41-30(1) (2007).

<sup>&</sup>lt;sup>107</sup> *Id.* 

<sup>&</sup>lt;sup>108</sup> *Id*.

 $<sup>^{109}\,</sup>$  S.D. Codified Laws § 43-31-1 (2008).

<sup>&</sup>lt;sup>110</sup> Tenn. Code Ann. § 26-2-301(a) (2008).

<sup>&</sup>lt;sup>111</sup> *Id*.

<sup>112</sup> Tex. Code Ann. Const. Art. XVI, § 51 (2007).

		town or city cannot exceed 200
		acres and, if in a city, town or
		village must consist of not more
		than 10 contiguous acres. <sup>113</sup>
Utah	$20,000^{114}$	Property that is not the primary
		personal residence of a debtor
		may be exempt up to \$5,000.115
		The maximum exemption that
		can be claimed on a homestead
		owned by more than one person is
		$$10,000^{116}$ for property that is not
		the primary, personal residence of
		its owners and \$40,000 <sup>117</sup> for
		property that is the primary
		personal residence of its owners.
Vermont	75,000118	None.
Virgin Islands	30,000119	The property cannot exceed five
		acres if outside of a town and 1/4
		acre if within a town. 120
Virginia	5,000121	Virginia allows a maximum

<sup>&</sup>lt;sup>113</sup> *Id*.

<sup>114</sup> Utah Code Ann. § 78-23-3(2) (2008).

<sup>115</sup> Utah Code Ann. § 78-23-3(2)(a)(i) (2008).

<sup>116</sup> Utah Code Ann. § 78-23-3(2)(b)(i) (2008).

<sup>117</sup> Utah Code Ann. § 78-23-3(2)(b)(ii) (2008).

<sup>118</sup> Vt. Stat. Ann. Tit. 27, § 101 (2007).

<sup>&</sup>lt;sup>119</sup> V.I. Code Ann. Tit. 5, § 478(a) (2008).

<sup>&</sup>lt;sup>120</sup> *Id*.

<sup>&</sup>lt;sup>121</sup> Va. Code Ann. § 34-4 (2008).

	<del>,</del>	<del></del>
		exemption of \$5,000 for a
		combination of real and/or
		personal property with an
		additional \$500 per dependent. 122
Washington	$125,000^{123}$	None.
West Virginia	$25,000^{124}$	Physicians licensed to practice
		medicine in the state are entitled
		to a homestead exemption of
		\$250,000 when filing for
		bankruptcy caused at least in
		part from a medical malpractice
		judgment as long as the physician
		maintained a malpractice
		insurance policy of at least one
		million dollars per occurrence. 125
Wisconsin	$40,000^{126}$	"The exemption extends to land
	]	owned by husband and wife
		jointly or in common or as marital
		property, and when they reside in
		the same household may be
		claimed by either or may be
		divided in any proportion between
		them, but the exemption may not
		exceed 40,000 for the
		household."127

<sup>&</sup>lt;sup>122</sup> *Id.* 

<sup>&</sup>lt;sup>123</sup> Wash. Rev. Code Ann. § 6.13.030 (LexisNexis2008).

<sup>124</sup> W. Va. Code § 38-10-4(a) (2008).

<sup>&</sup>lt;sup>125</sup> *Id*.

<sup>&</sup>lt;sup>126</sup> Wis. Stat. § 815.20(1) (2007).

<sup>&</sup>lt;sup>127</sup> *Id.* 

TT7 .	10 000128	l at
Wyoming	$10.000^{128}$	None.
11 J O III III G	10,000	110110:

# III. THE CURRENT SYSTEM FAILS TO PROVIDE A UNIFORM LAW FOR BANKRUPTCY

Allowing the states to opt out of the federal exemptions and set their own widely varying homestead exemptions has led to disproportionate results in the value of property that citizens from different states may retain after a bankruptcy decree that is difficult to justify. As the above table illustrates, citizens of Alabama, Kentucky, Maryland, Ohio, Tennessee and Virginia are limited to \$5,000 in the value of their homestead that they may exempt from attachment in a Chapter 7 proceeding, while citizens of Arkansas, Washington D.C., Florida, Iowa, Kansas, Oklahoma, South Dakota, and Texas enjoy an unlimited personal exemption for the equity in their primary residence. 129 Hence a bankruptcy filer in Arkansas with a \$1,000,000 home that is paid in full and unencumbered by a mortgage or other secured debt will be able to exclude the home from attachment in a Chapter 7 filing, whereas a New York resident under identical circumstances may exempt only \$50,000 of the home's \$1,000,000 equity and an Ohio resident in the identical circumstances may exempt only \$5,000 of the \$1,000,000 equity in her homestead. It is hard indeed to justify this result as reasonable based on analysis of cost of living differences among the states, real estate price differentials or any other rational basis.

Bankruptcy law is by no means the only area in which we tolerate significant differences in the protection that states provide

<sup>&</sup>lt;sup>128</sup> Wyo. Stat. Ann. § 1-20-101 (2007).

<sup>&</sup>lt;sup>129</sup> Texas, Kansas and Arkansas limit the maximum acreage of the homestead, though not its maximum value, as noted in Table 1.

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their citizens. States tend to protect debtors or lenders in other significant ways in their rightful exercise of their broad police powers as long as they can justify their actions by the rather broad rational basis test. What is particularly offensive in the disparate treatment of debtors tolerated by the Bankruptcy Code is that it involves not state action that would require the according of great deference to the wisdom of state legislators in passing laws for the common good of their citizens, but rather federal law that under Article I Section 8 of the U.S. Constitution places responsibility for a bankruptcy law squarely on the shoulders of Congress. 130 For Congress to allow such disparate treatment of citizens living in different states and territories violates the spirit of due process and equal protection clauses of the Fifth and Fourteenth Amendments. The nearly complete discretion of a state or territory to protect either debtors or creditors as it sees fit in decreeing what property a debtor may exempt from attachment in bankruptcy proceedings is an abdication by Congress of the responsibility to establish "uniform . . . Laws on the subject of Bankruptcies throughout the United States"131 squarely placed on its shoulders by the U.S. Constitution.

#### CONCLUSION

When the reforms in BAPCPA were implemented, Congress had the opportunity to revisit the homestead exemption and finally close the most glaring loophole in the Bankruptcy Act. Instead, Congress chose only to limit the exemption in two ways that fall far short of addressing the problem. First, Congress capped the homestead exemption at \$125,000 for property obtained within 1,215 days of the

U.S. Const. art. I, § 8, cl. 2 empowers Congress "[t]o establish a uniform rule of naturalization, and uniform laws on the subject of bankruptcies throughout the United States."

<sup>&</sup>lt;sup>131</sup> *Id*.

filing.<sup>132</sup> Second, Congress required a debtor to reside in the state for 730 days prior to filing the petition in order to take advantage of the state's homestead exemption.<sup>133</sup> In addition, BAPCPA caps the homestead exemption at \$125,000 in some instances involving abusive filings<sup>134</sup> and willful tortuous or criminal conduct by the debtor.<sup>135</sup> These changes aside, for individuals who resided in the state at least 730 days (two years) prior to the bankruptcy proceeding filing and who owned their homestead for at least 1,215 days (40 months) prior to the filing may still exclude the entire value of their homestead in seven states and in the District of Columbia.

The notable differences in cost of living and property values among the states and territories should be acknowledge by Congress in the Bankruptcy Code. Setting an arbitrary and inflexible system for the entire country would itself be unfair as median home values, cost of living, salaries, and other related criteria that impact on determining a fair and reasonable value of allowable personal and homestead exemptions for debtors can vary widely among the states and even in different regions within states. And allowing states to make the determination of what is fair and reasonable for their citizens is not an unreasonable standard, as long as minimum and maximum protections

<sup>&</sup>lt;sup>132</sup> 11 U.S.C. § 522(p).

<sup>133 11</sup> U.S.C. §522(b)(3).

<sup>134 11</sup> U.S.C. § 522(q)(1)(A) (If a debtors has been convicted of a felony and the court finds there to have been an abuse in filing for bankruptcy protection the homestead exemption is capped at \$125,000.)

<sup>135 11</sup> U.S.C. § 522(q)(1)(B). (The homestead exemption is capped at \$125,000 in cases in which the debtor owes a debt that arose out of (i) a violation of securities laws; (ii) fraud, deceit or manipulation in a fiduciary capacity or in connection with the purchase or sale of a security; (iii) civil RICO penalties under 18 U.S.C. § 1964; and (d) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding five years prior to the filing.)

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are put in place under the federal law. Thus a system whereby the federal exemptions are required as a minimum standard and states are allowed to give greater protection to their citizens who file for bankruptcy up to a set limit (e.g., \$125,000 or any other amount that Congress deems fair) would seem both reasonable and equitable. Unlimited homestead exemptions by states who wish to protect debtors, however, are as unreasonable as \$5,000 exemptions by states who wish to protect creditors. Continuing to tolerate such extremes creates a decidedly unequal law for bankruptcies throughout the U.S. and violates the spirit, if not the letter, of the Constitutional guarantees of equal protection and due process.

B L



#### COMMENT

Milavetz v. United States: So Bankruptcy Attorneys are Debt Relief Agencies, Right?

The Supreme Court in *Milavetz v. United States*<sup>1</sup> considered the question of whether bankruptcy attorneys are included in the definition of a debt relief agency,<sup>2</sup> a classification that is subject to certain restrictions under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA or the BAPCPA). This question arose almost immediately after Congress passed the BAPCPA in 2005<sup>3</sup> despite Congress broadly defining the term as "any person who provides bankruptcy assistance to an assisted person . . . ."<sup>4</sup> Aware of this unsettled question, and concerned with whether their bankruptcy

Milavetz, Gallop & Milavetz, P.A. v. United States, 176 L. Ed. 2d 79 (2010).

<sup>11</sup> U.S.C. § 101 (12A) (2006) (defining a debt relief agency as "any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer under section 110, but does not include – (A) any person who is an officer, director, employee, or agent of a person who provides such assistance or of the bankruptcy petition preparer; (B) a nonprofit organization that is exempt from taxation under section 501(c)(3) of the Internal Revenue Code of 1986; (C) a creditor of such assisted person, to the extent that the creditor is assisting such assisted person to restructure any debt owed by such assisted person to the creditor; (D) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act) or any Federal credit union or State credit union (as those terms are defined in section 101 of the Federal Credit Union Act), or any affiliate or subsidiary of such depository institution or credit union; or (E) an author, publisher, distributor, or seller of works subject to copyright protection under title 17, when acting in such capacity.").

See In re Attys. at Law, 332 B.R. 66 (Bankr. S.D. Ga. 2005) (issuing opinion on Oct. 17, 2005, the effective date of the bulk of the BAPCPA provisions, sua sponte holding that attorneys in the Bankruptcy Court for the Southern District of Georgia were not bound by the requirements of a debt relief agency), appeal dismissed, 353 B.R. 318 (S.D. Ga. 2006).

<sup>4 § 101 (12</sup>A).

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attorneys would be subject to the requirements of a debt relief agency, Milavetz Gallop & Milavetz, instituted an action in the United States District Court for the District of Minnesota in 2006.<sup>5</sup>

Their case centered around two main arguments. First, they asserted that attorneys were not expressly included within the statutory definition and should therefore not be held subject to the requirements of a debt relief agency.<sup>6</sup> In the alternative, if the definition covered attorneys, they claimed the doctrine of constitutional avoidance counseled against including attorneys within the definition because two specific requirements of a debt relief agency would impinge on an attorney's constitutional rights.7 They argued the restriction on advising a client from "incur[ring] more debt in contemplation" of filing for bankruptcy is either unconstitutionally vague<sup>8</sup> or that it violated the First Amendment.<sup>9</sup> They also claimed the advertising disclosure requirements of a debt relief agency violated an attorney's First Amendment right. 10 Were the doctrine of constitutional avoidance not to apply, Milavetz argued these provisions nevertheless were unconstitutional and should be inapplicable to bankruptcy attorneys.<sup>11</sup>

The district court agreed with Milavetz's alternative argument, citing the doctrine of constitutional avoidance as reason for holding the debt relief agency requirements inapplicable to bankruptcy attorneys. 12 The government appealed and a divided United States Court of Appeals, Eighth Circuit reversed on the principal issue,

<sup>&</sup>lt;sup>5</sup> Milavetz, Gallop & Milavetz, P.A. v. United States, 355 B.R. 758 (D. Minn. 2006).

<sup>6</sup> *Id.* at 767.

<sup>&</sup>lt;sup>7</sup> Id. at 768.

<sup>8</sup> Id. at 765.

<sup>&</sup>lt;sup>9</sup> Id. at 763.

<sup>10</sup> Id. at 766.

<sup>11</sup> *Id.* at 762.

<sup>12</sup> Id. at 769.

holding the definition covered attorneys.<sup>13</sup> However, the Eighth Circuit affirmed the district court's decision holding that a restriction on an attorney's ability to advise a client to incur additional debt in contemplation of a bankruptcy filing was unconstitutional.<sup>14</sup> Each side appealed and the Supreme Court granted both writs for certiorari.<sup>15</sup> In a near unanimous decision, the Court held in favor of the government, saying attorneys who provide qualifying services are debt relief agencies and that none of the specified provisions violated an attorney's constitutional rights.<sup>16</sup>

#### I. BACKGROUND

# A. RELEVANT PRECEDENT CONCERNING STATUTORY INTERPRETATION

As stated by the Supreme Court most recently in *Barnhardt v.* Sigmon Coal Co., statutory interpretation begins with a look at the plain meaning of the statute, and only where the text is ambiguous would the analysis look to extrinsic material such as legislative history. At times, the plain meaning of a statute may raise questions as to whether the statute is constitutional. In these instances, the doctrine of constitutional avoidance might apply. The doctrine states that if two or more interpretations of the statute are fairly possible, but one would present serious constitutional problems, the Court will construe the statute in accordance with the interpretation that avoids

Milavetz, Gallop & Milavetz, P.A. v. United States, 541 F.3d 785, 797 (8th Cir. 2008).

<sup>14</sup> Id. at 794.

United States v. Milavetz, Gallop & Milavetz, P.A., 129 S. Ct. 2766 (2009) (granting writ for the government); Milavetz, Gallop & Milavetz, P.A. v. United States, 129 S. Ct. 2769 (2009) (granting writ for Milavetz).

<sup>&</sup>lt;sup>16</sup> Milavetz, Gallop & Milavetz, P.A. v. United States, 176 L. Ed. 2d 79, 97 (2010).

<sup>17 534</sup> U.S. 438, 450 (2002).

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these constitutional problems.<sup>18</sup> A majority of lower courts addressing this issue have interpreted the definition of debt relief agencies to plainly include bankruptcy attorneys.<sup>19</sup>

B. RELEVANT PRECEDENT APPLICABLE TO DETERMINING THE SCOPE AND VALIDITY OF RESTRICTIONS ON ADVICE GIVEN BY A DEBT RELIEF AGENCY

Under the BAPCPA a debt relief agency is prohibited from "advis[ing] an assisted person or prospective assisted person to incur more debt in contemplation of" filing for bankruptcy. 20 At the center of the issue is the interpretation of the phrase "in contemplation of." The provision would present First Amendment concerns if the phrase was read broadly to prohibit any advice an attorney were to provide to a client contemplating bankruptcy. However, if construed narrowly, the provision would only proscribe certain types of advice, and would present an issue of vagueness that might render it unconstitutional. A majority of the lower courts have held this provision to be unconstitutional as applied to attorneys, construing the provision broadly to prohibit a debt relief agency from advising an assisted

See, e.g., United States v. Sec. Indus. Bank, 459 U.S. 70, 78 (1982) (quoting Lorillard v. Pons, 434 U.S. 575, 577 (1978)); See also Edward J. DeBartolo Corp. v. Fla. Gulf Coast Bldg. & Constr. Trades Council, 485 U.S. 568, 575 (U.S. 1988)("This cardinal principle has its roots in Chief Justice Marshall's opinion for the Court in Murray v. The Charming Betsy, 2 Cranch 64, 118 (1804), and has for so long been applied by this Court that it is beyond debate.").

See Hersh v. United States, 553 F.3d 743, 752 (5th Cir. 2008); Connecticut Bar Ass'n v. United States, 394 B.R. 274, 280 (D. Conn. 2008); In re Irons, 379 B.R. 680, 685 (Bankr. S.D. Tex. 2007); Olsen v. Gonzales, 350 B.R. 906, 912 (D. Or. 2006)

<sup>20 11</sup> U.S.C. § 526(a)(4) (2006).

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person from incurring *any* type of debt when contemplating a bankruptcy filing.<sup>21</sup>

### C. RELEVANT PRECEDENT APPLICABLE TO DETERMINING WHETHER THE DISCLOSURE REQUIREMENTS ARE CONSTITUTIONAL

The disclosure requirements at issue in *Milavetz* require a debt relief agency to advertise "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code.' or a substantially similar statement."<sup>22</sup> While the Supreme Court has examined the constitutionality of commercial speech disclosure requirements in the past, courts have not uniformly applied one

See Connecticut Bar Ass'n, 394 B.R. at 282 (interpreting the phrase broadly to "prohibit" attorneys from advising their clients to incur any kind of debt prior to filing for bankruptcy, including debts that are legal and desirable in certain instances."); Zelotes v. Martini, 352 B.R. 17, 25 (D. Conn. 2006) (holding the restriction on advice unconstitutionally overbroad because it "prohibit[s] lawyers from advising clients to take lawful, prudent actions. . . ."; Olsen, 350 B.R. at 916 (holding the restriction on advice included both lawful and abusive actions and was therefore in violation of the First Amendment); But see Hersh, 553 F.3d at 756 (holding § 526(a)(4) to be construed narrowly to prohibit only advice to abuse the bankruptcy system).

<sup>22 11</sup> U.S.C. § 528(a)(4) (2006) ("(a) A debt relief agency shall – (4) clearly and conspicuously use the following statement in any [advertisement of bankruptcy assistance services or of the benefits of bankruptcy directed to the general public (whether in general media, seminars or specific mailings, telephonic or electronic messages, or otherwise)]: "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code." or a substantially similar statement." ); 11 U.S.C. (b)(2)(B) ("(b)(2) An advertisement, directed to the general public, indicating that the debt relief agency provides assistance with respect to credit defaults, mortgage foreclosures, eviction proceedings, excessive debt, debt collection pressure, or inability to pay any consumer debt shall—(B) include the following statement: "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code." or a substantially similar statement.").

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standard to all disclosure requirements.<sup>23</sup> Generally if it is a restriction on misleading advertisements it's subject to the *Zauderer* standard and must be "reasonably related to the State's interest in preventing deception of consumers."<sup>24</sup> Restrictions on non-misleading commercial speech are subjected to the higher standard announced by the Court in *Central Hudson*.<sup>25</sup> Regarding the disclosure requirements relevant in *Milavetz*, the lower courts have not been unanimous in their conclusions as to what standard to apply<sup>26</sup> or in their conclusions as to the disclosure requirement's constitutionality.<sup>27</sup>

#### II. ANALYSIS

Justice Sotomayor, writing for the Court determined the case by finding the statutory text clearly covered bankruptcy attorneys as debt relief agencies and that the doctrine of constitutional avoidance was not a factor because the requirements of debt relief agencies did not raise any constitutional problems when applied to attorneys.<sup>28</sup>

<sup>23</sup> See N.Y. State Rest. Ass'n v. N.Y. City Bd. of Health, 556 F.3d 114 (2d Cir. 2009) (applying Zauderer to a disclosure requirement); United States v. Wenger, 427 F.3d 840 (10th Cir. 2005) (applying both Zauderer and Central Hudson in combination to a disclosure requirement); Borgner v. Brooks, 284 F.3d 1204 (11th Cir. 2002) (applying Central Hudson to a disclosure requirement).

Zauderer v. Office of Disciplinary Counsel of Supreme Court, 471 U.S. 626, 651 (1985).

<sup>&</sup>lt;sup>25</sup> Cent. Hudson Gas & Elec. Corp. v. Public Serv. Comm'n, 447 U.S. 557 (1980).

See Olsen v. Gonzales, 350 B.R. at 920 (applying Central Hudson, although the court stated Zauderer might be more applicable); Connecticut Bar Ass'n, 394 B.R. at 290 (applying Zauderer).

<sup>27</sup> See Olsen v. Gonzales, 350 B.R. at 920 (holding the disclosure requirements constitutional); Connecticut Bar Ass'n, 394 B.R. at 290 (holding the disclosure requirements constitutional as applied to attorneys representing consumer debtors but unconstitutional as applied to attorneys representing non-consumer debtors).

<sup>&</sup>lt;sup>28</sup> Milavetz, 176 L. Ed. 2d at 97.

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First, Justice Sotomayor examined whether the statutory text plainly included attorneys as debt relief agencies.<sup>29</sup> Important to the Court was the fact that the definition of "bankruptcy assistance" "includes several services commonly performed by attorneys[,]" and some services that "may be provided only by attorneys."<sup>30</sup> The Court also found instructive the fact that Congress provided exclusions to the definition of debt relief agencies, but showed no indication of the intent, expressed or implied, to exclude attorneys.<sup>31</sup>

The Court then considered Milavetz's arguments, but dismissed their reading of the statute as implausible and stated Congress did not "impermissibly trench" on the State's traditional role in regulating attorneys. Milavetz argued that where an "officer, director, employee or agent of a person who provides bankruptcy assistance" was excluded from being a debt relief agency, a "partner" was not. Milavetz was concerned with the possibility of binding an entire law firm to the requirements of a debt relief agency where only one partner is engaged in bankruptcy assistance. The Court agreed with this reading of the statute and stated this "is consistent with the joint responsibilities that typically flow from the partnership structure. The Court refused to apply the doctrine of constitutional avoidance because a reading of the definition to exclude attorneys was not "fairly possible."

<sup>&</sup>lt;sup>29</sup> Id. at 86.

<sup>30</sup> Id. at 87 (referring to "services sold or otherwise provided to an assisted person with the express or implied purpose of providing . . . advice, counsel, document preparation . . . or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title." 11 U.S.C. § 101(4A)(2006) (emphasis added)).

<sup>31</sup> Id.

<sup>32</sup> Id. at 88.

<sup>&</sup>lt;sup>33</sup> *Id*.

<sup>34</sup> *Id*.

<sup>35</sup> Id.

<sup>36</sup> Id. at 88-89.

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Next, the Court considered the scope and validity of the restrictions on providing advice.<sup>37</sup> The government advocated for a narrow reading of the phrase "in contemplation of" that would only prohibit a debt relief agency from advising a client to abuse the bankruptcy system.<sup>38</sup> Milavetz argued for a broader reading that would bar an attorney from advising a client contemplating bankruptcy to incur more debt that would be in the client's best interest, such as refinancing a mortgage to acquire a lower interest rate or to purchase a reliable car to improve their ability to repay.<sup>39</sup> They argued this broad reading was violative of an attorney's First Amendment right to free speech and also in the alternative, Milavetz argued the narrow reading that the government advanced would be unconstitutionally vague. 40 The Court consulted a previous interpretation of the phrase "in contemplation of" adopted by the Court,<sup>41</sup> and looked at the broader context of the provision within the statute.<sup>42</sup> This led the Court to construe the phrase narrowly to prohibit only advice a debt relief agency provides to its client where the "impelling reason for the advice is the anticipation of bankruptcy." 43

<sup>37</sup> Id. at 89.

<sup>&</sup>lt;sup>38</sup> *Id*.

<sup>&</sup>lt;sup>39</sup> *Id*.

<sup>&</sup>lt;sup>40</sup> Id.

<sup>41</sup> *Id.* at 91.

<sup>42</sup> Id. at 92.

<sup>43</sup> Id. The Court previously examined the meaning of the phrase "in contemplation of" in Conrad v. Pender, 289 U.S. 472 (1933). There the Court took the position that to determine if an action was "in contemplation of the filing of a petition" the "controlling question" was "whether the thought of bankruptcy was the impelling cause of the transaction." Id. at 477. Justice Sotomayor adopted this same interpretation and added that advice given by a debt relief agency "to incur more debt because of bankruptcy" would "generally consist of advice to 'load up' on debt with the expectation of obtaining its discharge – i.e., conduct that is abusive per se." Milavetz, 176 L. Ed. 2d at 91. The Court then mentioned two contextual reasons that provided support for this conclusion. Id. at 92. First, because the BAPCPA's system for determining whether a debtor would be able to repay was

The Court analyzed the reading the government advanced and stated it would not be unconstitutionally vague because the concept of abuse was a well-defined standard within the Bankruptcy Code.<sup>44</sup> The interpretation the Court adopted was not unconstitutionally vague because the Court saw the scope of the provision "adequately defined, both on its own terms and by reference to the Code's other provisions. . "45"

The disclosure requirements were similarly found to be constitutional as applied to attorneys. 46 Critical to this was the Court's finding that Zauderer was to apply because the regulation was aimed at inherently misleading commercial speech, and the particular regulations were similar to those in Zauderer. 47 In applying Zauderer the Court said the disclosure requirements were reasonably related to the government's interest in preventing consumer deception. 48 The Court stated the term "debt relief agency" was not confusing because the disclosure requirements forced bankruptcy attorneys in their advertising to inform the public of their services, which included helping people file for bankruptcy relief, and therefore "provide[d] additional assurance that consumers [would] not misunderstand the term." 49

highly subject to abuse, the Court saw this restriction on advice as a preventative measure taken against the potential abuse. *Id.* Second, the Court stated that the provisions adjacent to the restrictions on advice all evinced a concern for protecting against acts that would harm creditors and debtors. *Id.* Were the phrase to be interpreted narrowly, this would protect creditors and debtors from advice to abuse the bankruptcy system, but if it were read broadly it would bar advice that "would likely benefit both debtors and creditors" and therefore conflict with the context's purpose. *Id.* 

<sup>44</sup> Id. at 93-94.

<sup>45</sup> *Id.* at 94.

<sup>46</sup> Id. at 97.

<sup>47</sup> Id. at 95.

<sup>&</sup>lt;sup>48</sup> *Id.* at 97.

<sup>49</sup> Id. at 96.

# MILAVETZ V. UNITED STATES: SO BANKRUPTCY ATTORNEYS ARE DEBT RELIEF AGENCIES, RIGHT?

Justice Scalia, while concurring in the judgment, warned "much can be lost" by the Court recognizing legislative history within an opinion that found the statutory text is clear and unambiguous.<sup>50</sup> He disagreed with the decision to include footnote three within the majority opinion in which Sotomayor explained that the legislative history provided support for the majority's reasoning.<sup>51</sup> His main concern is that attorneys will now mechanically use legislative history to buttress an argument notwithstanding the "case where the statutory text is unambiguously in their favor . . . ."<sup>52</sup>

In his concurrence, Justice Thomas emphasized "the posture of Milavetz's challenge" of the disclosure requirements "inhibit[ed] [the Court's] review of its First Amendment claim." 53 Milavetz did not provide any examples of their advertisements for the Court to consider, 54 and therefore the Court's analysis resembled a facial challenge, which presents a high standard for the challenger to overcome. 55 Because there was at least one "conceivabl[e]' manner in which [the disclosure requirements could] be enforced consistent with the First Amendment[,]" they were held to be constitutional as applied to Milavetz. 56

### III. EVALUATION

<sup>50</sup> Id. at 97-98 (Scalia, J., concurring).

Id. Although Sotomayor stated within footnote three, "reliance on legislative history is unnecessary in light of the statute's unambiguous language. . . ." Id. at 87 n.3 (majority opinion).

<sup>&</sup>lt;sup>52</sup> *Id.* at 98(Scalia, J., concurring).

<sup>53</sup> *Id.* at 100 (Thomas, J., concurring).

<sup>54</sup> *Id.* at 79 (majority opinion).

<sup>&</sup>lt;sup>55</sup> Id. at 101 (Thomas, J., concurring). ("When forced to determine the constitutionality of a statute based solely on such conjecture, we will uphold the law if there is any 'conceivabl[e]' manner in which it can be enforced consistent with the First Amendment.") (citation omitted).

Id. at 101 (quoting Washington State Grange v. Washington State Republican Party, 552 U.S. 442, 456 (2008)).

The Court's opinion in *Milavetz* is properly grounded in precedent and logically comes to the conclusion that attorneys who provide qualifying services are debt relief agencies for purposes of the BAPCPA. Although the Court attempts to clarify the scope of advice a debt relief agency is permitted to provide to a client,<sup>57</sup> a great deal of questions remain as to how one is to determine whether the impelling reason for providing the advice was the anticipation of bankruptcy. Additionally, the holding does not foreclose further as applied challenges of the disclosure requirements, which could mean some practitioners will not be required to include them in their advertising.

The Court properly restricted its statutory interpretation to the specific language at issue and its broader context in determining the scope of both the debt relief agency definition and the scope of restricted advice. Recent jurisprudence on statutory interpretation has demonstrated that unless the text is ambiguous, the statutory text is the single source the Court is to look at when interpreting the text.<sup>58</sup> Justice Scalia, as here, has continually acted as a watchdog to ensure legislative history is not a factor in that analysis unless the text is truly ambiguous.<sup>59</sup> The Court correctly looked at the broad definition of debt relief agency and the exceptions to the definition, which

<sup>57</sup> Id. at 92-93.

<sup>58</sup> Barnhart v. Sigmon Coal Co., 534 U.S. 438, 450 (2002).

See Blanchard v. Bergeron, 489 U.S. 87, 98-99 (1989) (Scalia, J concurring) ("It is neither compatible with our judicial responsibility of assuring reasoned, consistent, and effective application of the statutes of the United States, nor conducive to a genuine effectuation of congressional intent, to give legislative force to each snippet of analysis, and even every case citation, in committee reports that are increasingly unreliable evidence of what the voting Members of Congress actually had in mind."); Thompson v. Thompson, 484 U.S. 174, 191-92 (1988) (Scalia, J., concurring in the judgment) ("Committee reports, floor speeches, and even colloquies between Congressmen are frail substitutes for bicameral vote upon the text of a law and its presentment to the President.") (citation omitted).

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specifically lists six but does not mention attorneys, and concluded the context in which the provision is located indicates attorneys are debt relief agencies for purposes of the BAPCPA. Concerning the scope of prohibitions on client advice, the Court also constrained its analysis to the specific provision and its immediate context. 60 The Court appropriately recognized that the restriction on advice was located amongst three subparts that all evince a concern for practices that "threaten to harm debtors or creditors." 61 It would be strange for Congress to prohibit lawful, prudent advice, which would in most cases benefit the debtor, creditor and the court system. This is especially true where the provision is placed amongst other restrictions that serve to protect against actions detrimental to the debtor and creditor. Supreme Court precedent states that to determine the meaning of the words in a statute the Court is to look at "the language itself, the specific context in which that language is used, and the broader context of the statute as a whole."62 In this case, the United States provided compelling contextual reasons for a narrow reading where Milayetz provided little to support its legal conclusion that the term barred all advice. Therefore the Court accurately determined the provision's context counseled for a narrow reading of the restriction.

The Court's conclusion that the restrictions on advice are not unconstitutionally vague, however, is questionable, and this will most likely be revealed in future cases. Strangely, the Court's brief analysis of the vagueness issue defends a characterization of the provision that the Court did not adopt.<sup>63</sup> The Government proffered,<sup>64</sup> and Milavetz argued against,<sup>65</sup> a reading of the restrictions on advice to bar only

<sup>60</sup> Milavetz, 176 L. Ed. 2d at 91-92.

<sup>61</sup> Id. at 92.

<sup>62</sup> Robinson v. Shell Oil Co., 519 U.S. 337, 341 (1997).

<sup>63</sup> Milavetz, 176 L. Ed. 2d at 94-94.

<sup>64</sup> Id. at 89.

<sup>65</sup> Id.

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advice that would abuse the bankruptcy system.<sup>66</sup> This is not the narrow construction the Court adopted.<sup>67</sup> The Court instead construed the phrase to bar only advice "principally motivated by the prospect of bankruptcy . . . ."<sup>68</sup>

The Court presumably assumed that a standard based on abuse was more vague than a standard based on finding whether the principal motivation of an attorney's advice was the anticipation of bankruptcy, and therefore if able to refute the vagueness of the abuse standard, would not need to defend the standard the court actually adopted. This assumption, though, is incorrect. A statute is unconstitutionally vague where it "fails to provide a person of ordinary intelligence fair notice of what is prohibited."69 The concept of abuse, as the Court points out, is no stranger to the Bankruptcy Code and is used in a number of other contexts to guide a court in determining whether the Code has been violated.<sup>70</sup> How though is a court to determine the principal motivation of an attorney's advice where there are countless rationales for the advice? Once the principal motivation is identified, how are we to determine what the Court means by "anticipation of bankruptcy?" The Court in footnote six implies the answer is found somewhere between an "awareness of the possibility of bankruptcy" and the prospect of filing for bankruptcy with the expectation of its discharge. 71 This lacuna leaves practitioners without a guide to determine what types of advice are prohibited and discredits the Court's conclusion that the restriction is not unconstitutionally vague.

The Court correctly determined the *Zauderer* standard was applicable to the disclosure requirements and properly applied that

<sup>66</sup> Id.

<sup>67</sup> Id. at 94.

<sup>68</sup> Id.

<sup>69</sup> United States v. Williams, 128 S. Ct. 1830, 1845 (2008).

<sup>&</sup>lt;sup>70</sup> Milavetz, 176 L. Ed. 2d at 93-94.

<sup>71</sup> *Id.* at 94 n.6.

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standard in holding them to be constitutional. The rational basis test under Zauderer is virtually always detrimental to the challenger's case, and consequently, it's no surprise the Court held the disclosure requirements were reasonably related to the government interest in preventing consumer deception, and therefore constitutional. The Court applied Zauderer because the commercial speech at issue was inherently misleading, 72 however the Court has never determined exactly what makes speech inherently misleading. In Zauderer the Court determined that an advertisement is inherently misleading where it announces "that if there is no recovery, no legal fees are owed[.]" but doesn't distinguish between legal fees and costs, therefore prompting a layperson to mistakenly assume they would owe the attorney nothing if there was no recovery. 73 In Milavetz, the Court states the inherently misleading commercial speech was "a pattern of advertisements that [held] out the promise of debt relief without alerting consumers to its potential cost"74 or that bankruptcy was the means to accomplish the debt relief.75

The advertisements in Zauderer implicitly addressed a consumer's question as to how much the services would cost, leading consumers to believe the services were essentially free of charge. However, the advertisements in Milavetz merely refrained from answering that question. It's arguable that the commercial speech at issue in Zauderer is more inherently misleading than the speech in Milavetz, but this only shows that the Court's threshold for proving inherently misleading speech is at least as low as the advertisements at issue in Milavetz. This is consistent with the court's position that deceptive commercial speech is to be afforded less constitutional

<sup>&</sup>lt;sup>72</sup> *Id.* at 96.

Zauderer v. Office of Disciplinary Counsel of Supreme Court, 471 U.S. 626, 652 (1985).

<sup>&</sup>lt;sup>74</sup> *Milavetz*, 176 L. Ed. 2d at 96.

<sup>&</sup>lt;sup>75</sup> *Id.* at 100 (Thomas, J., concurring).

protection,<sup>76</sup> and serves as a warning to advertisers. The ruling informs advertisers the government has a strong mandate when it takes aim at regulating commercial speech that has the ability to deceive consumers as to the costs associated with the goods or services advertised.

Bankruptcy practitioners looking to avoid placing the disclosure requirements in their advertising are not left entirely without a remedy. The Court makes clear, 77 and Justice Thomas elaborates on the point that because Milavetz failed to present examples of its advertisements, the as-applied challenge to the disclosure requirement resembled more of a facial challenge. 78 Therefore, if a challenger is able to present examples of their advertisements and demonstrate they are in no way deceptive, they would have a good chance at establishing the disclosure requirements, as applied, violated their First Amendment right under *Zauderer*, and would be inapplicable to them. 79

### CONCLUSION

The Court was able to unanimously agree in the judgment in *Milavetz*, but this does not mean attorneys will not continue to fight the requirements of a debt relief agency or that all questions were answered. This comment attempts to highlight the unanswered questions regarding the restrictions on advice that will hopefully be fleshed out in both scholarly works and in the case law. Regarding the disclosure requirements, there is a palpable chance that bankruptcy

<sup>&</sup>lt;sup>76</sup> Zauderer, 471 U.S. at 652.

<sup>&</sup>lt;sup>77</sup> Id. at 100 (Thomas, J., concurring).

<sup>78</sup> *Id.* at 94 (majority opinion).

<sup>&</sup>lt;sup>79</sup> The government would not have an interest in protecting from the deception of the challenger's consumers under *Zauderer*, and therefore the regulation could not be reasonably related to the government interest in protecting from consumer deception.

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attorneys looking to avoid the disclosure requirements will be able to present a case that would render the disclosure requirements inapplicable to them. If Congress did indeed wish to include attorneys within the definition of a debt relief agency, they surely did not want attorneys to avoid placing the disclosure requirements in their advertising. Hopefully the Court laid out both its statutory interpretation doctrine and First Amendment commercial speech standards clearly enough for Congress to avoid these issues in future legislation.

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#### COMMENT

Originalism and Citizens United: The Struggle of Corporate Personhood

With the ruling of Citizens United v. Federal Election Commission, the issue of corporate personhood has reemerged. Corporate personhood is the concept that the federal Constitution provides for equal identity between corporations and persons. Since the nineteenth century, our highest court has debated the legitimacy of corporate personhood.<sup>2</sup> Although a seemingly benign classification, corporate personhood legitimization may provide for a very convincing argument to further restrain corporate regulation. Quite logically, companies would proclaim that if corporations and persons have equal legal identities, they should likewise have equal rights; an argument which has been asserted by several corporations prior to Citizens *United*.<sup>3</sup> Such a notion leads one to wonder – with corporate personhood legitimacy, how will American citizens value fundamental rights? Moreover, in providing such extensive equality, would corporations come out the true victors; possessing more rights than their human counterparts.4

When confronted with the corporate personhood dilemma, or sub-issues thereof, it is difficult to choose the specific modality most efficient to resolve the problem. However, as with most convoluted constitutional qualms, originalism proves most fit. Originalism requires much more thought than other modalities. It requires one to determine what principle was sought by the Framers when constructing a particular Constitutional Article or Amendment and

<sup>&</sup>lt;sup>1</sup> See Citizens United, 130 S. Ct. 876 (2010).

<sup>&</sup>lt;sup>2</sup> See Dartmouth College v. Woodward, 17 U.S. 518, 636 (1819) (Justice Marshall refers to a corporation as "an artificial being...existing only in contemplation of law").

See Citizens United at 876; see also Santa Clara County v. Southern P.R.Co., 118 U.S. 394 (1886) (where the Southern Pacific Railroad Company asserts its Fourteenth Amendment rights); see also Dow Chem. Co. v. United States, 476 U.S. 227 (1986) (where Dow Chemical Company asserts its right to privacy); see also Nike, Inc. v. Kasky, 539 U.S. 654 (2003) (where Nike asserts its right to free speech); see also Blackwater Lodge & Training Ctr., Inc. v. Broughton, No. 08-CV-0926 (U.S. Dist. June 17, 2008) (where Blackwater asserts its due process rights); see also Commonwealth Brands, Inc. v. United States, No. 1:09-CV-117-M (U.S. Dist. Jan. 14, 2010) (where tobacco companies assert their free speech and due process rights).

<sup>4</sup> Such as lack of personal liability and imprisonment.

how to apply that principle to the given issue.<sup>5</sup> To deduce what principle was sought, one has to abstract from history relevant text, events, and letters from the Framers on certain topics.<sup>6</sup> From there, the principle is then reconciled with the issue as best as possible; and in most cases, it provides support for whether to strike down or uphold a statute.<sup>7</sup>

Since deciding how to implement originalism can be a daunting task, it is helpful to analogize it with the usefulness of advice.<sup>8</sup> Advice is best used as a suggestion, but not a definitive decision. Thus, one should take advice and use it with consideration of other advice and ideas. Likewise, originalism should be used in the same manner. Although it is problematic to disregard the originalist modality, it also should not be solely determinative.<sup>9</sup> It should be considered in conjunction with modern principles; modern principles having more deference when original intent is ambiguous.

Noticeably, *Citizens United* is a case that struggles with originalism.<sup>10</sup> The opinion fails to persuade us that the Framers specifically intended to supply corporations with First Amendment rights to free speech. Instead, the Court takes us on a long journey, providing a historical recitation of legislative and judicial opinion about corporate free speech, but at no time are we offered information on the Framers' intent.<sup>11</sup> We actually receive more insight into

Other theorists note that originalism would require one to ask a specific question about an issue related to what the Framers intended and to determine how the Framers would have applied their text to the problem. See Bobbit, The Modalities of Constitutional Argument, 12-22 (1991) (In the section on Constitutional Interpretation, he discusses what he calls the "historical modality"); however, his version of this modality is most akin to what many theorists consider originalism.

<sup>&</sup>lt;sup>6</sup> See id (again recognizing that his discussion of the historical modality is synonymous with originalism).

<sup>7</sup> See id.

See Sager, Lawrence, Justice in Plainclothes: A Theory of American Constitutional Practice, 30-42 (2004) (In Chapter 2, entitled "Judges as Agents of the Past: The Burden of Originalism", he discusses the difficulty of originalism and how such an interpretation requires the judges to interpret using a "normative" understanding of the doctrine).

<sup>&</sup>lt;sup>9</sup> See Grey, Thomas, Do We Have an Unwritten Constitution, 21 STAN.L.REV. 703-717 (1975).

See Citizens United at 948 (Stevens, J., dissenting) ("The Court invokes 'ancient First Amendment principles...and original understandings to defend today's ruling, yet it makes only a perfunctory attempt to ground its analysis in the principles or understandings of those who drafted and ratified the Amendment").

See id at 899-901 (where Justice Kennedy discusses the legislative and judicial history of corporate free speech).

original intent in the battle between the concurring and dissenting opinions.<sup>12</sup> At best, Justice Kennedy only provides discourse on how the Framers' may not have anticipated modern corporations.<sup>13</sup> Not only does the opinion leave us with a void as to whether the Founders intended for corporate free speech, but, like similar opinions expanding corporate constitutional rights, it fails to acknowledge the big pink elephant in the room – corporate personhood.<sup>14</sup>

### I. Did the Framers Intend to Recognize Corporations as Persons?

A textual and historical analysis of the recognition of persons and artificial persons 15 in the Constitution will best elucidate the Framers intent for corporate personhood legitimization. However, to comprehensively scrutinize every Article and Amendment would be a tedious and unnecessary task. The most efficient approach is to review those Amendments to which corporations have already proclaimed their equal rights. This would include a review of the First, Fourth, Fifth, and Fourteenth Amendments.<sup>16</sup> The most important part of the evaluation is to determine whether the text of the Constitution or the text of any of the Framers' correspondence specifically provides for corporate personhood legitimatization. In areas lacking such specificity, we may look to strong inferences of corporate personhood located in the Constitution's text, the Framers' documents, letters, events, and relevant surrounding circumstances or cases. Closely analyzing the four aforementioned Amendments, typically known for representing individual rights, will get us closer to resolving whether the Framers intended to legitimize corporate personhood.

See id at 948-53 (where Justice Stevens discusses original understanding of the First Amendment and the Framers' perception of corporations); See also Citizens United at 925-930 (where Justice Scalia offers a rebuttal to Justice Stevens dissenting opinion about original understanding).

<sup>13</sup> Id. at 905.06.

<sup>14</sup> See id, see also First Nat. Bank of Boston v. Bellotti, 435 U.S. 765 (1978) (where the Supreme Court held that corporations shared the same First Amendment freedom of speech as natural persons).

See Dartmouth at 636 (Justice Marshal references corporations as artificial beings).

See Citizens United at 876 (First Amendment claim); see also Dow at 227 (Fourth Amendment claim); see also Blackwater at No. 08 CV-0926 (Fifth Amendment claim); see also Nike at 654 (First Amendment claim); see also Commonwealth Brands at No. 1:09 CV-117-M (First, Fifth Amendment claims); see also Santa Clara County at 394 (Fourteenth Amendment claim).

First Amendment: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances." <sup>17</sup>

The First Amendment is one of the few constitutional Amendments with several clauses. Therefore, a cohesive historical analysis requires a separate evaluation of each clause, including the Establishment and Free Exercise Clauses, the Free Assembly Clause, The Petition Clause, and the Free Speech and Free Press Clauses.

The Establishment and Free Exercise Clauses <sup>18</sup> state that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." <sup>19</sup> The Establishment Clause has been generally interpreted to prohibit the establishment of a national religion by Congress or the preference of one religion over another; <sup>20</sup> while the Free Exercise Clause refers to the ability to actively participate in one's religion. <sup>21</sup> Taken together, the two clauses represent constitutional religious freedom, purposely indoctrinated as a reaction to the Church of England's religious oppression. <sup>22</sup>

As shown above, the clauses do not mention to which entities they apply. Therefore, there is no textual support that corporations and persons are equally entitled to religious freedom. Conversely, the Framers' general perception of the clauses provides compelling evidence. In 1802, Thomas Jefferson wrote a letter to the Danbury Association, coining the modern First Amendment notion of "separation of church and state." Proclaiming religions as "a matter which lies solely between man and his god," he emphasizes his goal to "see with sincere satisfaction the progress of those sentiments which tend to restore to man all his natural rights." Although the letter makes no reference to corporations, it makes no precise distinction either. Moreover, Jefferson's references to "man" and the idea that

<sup>&</sup>lt;sup>17</sup> U.S. Const. amend. I.

<sup>&</sup>lt;sup>18</sup> Hereinafter referred to as the religion clause. [hereinafter "Religion Clause"].

<sup>19</sup> See U.S. Const. amend. I.

<sup>20</sup> See Thomas Jefferson's Letter to Danbury Association, Jan. 1, 1802, available at http://www.loc.gov/loc/lcib/9806/danpost.html (Library of Congress).

<sup>21</sup> See id.

<sup>&</sup>lt;sup>22</sup> See Blackstone, William, Sir., Commentaries on the Laws of England (1765).

<sup>23</sup> See Thomas Jefferson's Letter to Danbury Association, Jan. 1, 1802, available at http://www.loc.gov/loc/lcib/9806/danpost.html (Library of Congress).

<sup>24</sup> Id (emphasis added).

<sup>25</sup> See id.

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religious freedom applies to man as a "natural right" shall not overshadow the recipient to whom the letter is addressed. <sup>26</sup> Jefferson was responding to the Danbury Association's letter expressing its desire that, as President, he maintain their religious freedom. <sup>27</sup> Therefore, although Jefferson used the term *man* in penning his response, he was specifically addressing an association. Hence, the concept of religious freedom was most likely inclusive, extending to man as well as the recipient and like entities (associations).

Unlike the other clauses, the Freedom of Assembly Clause distinctively references its intended beneficiaries. This Clause provides for "the right of the people peaceably to assemble." Like the Religion Clause, it was rejoinder to the Church of England's earlier prohibitions on religious gathering.<sup>28</sup> Although not directly textualized until the drafting of the Constitution, the right to assemble was an early American tradition.<sup>29</sup> Nevertheless, neither the text, nor the Framers' correspondence or surrounding events, substantiates this right as intended to protect any classification beyond persons.

In contrast, the founding era cases provide a strong inference that the Right to Petition Clause was meant to recognize persons and artificial persons. The Clause grants the right "to petition the Government for a redress of grievances." The right to petition one's government is a right rooted in British precedent. Ull before the Framers propounded the First Amendment, such petitioning was a part of the American common law tradition. This tradition is exemplified in the Declaration of Independence, which states "In every stage of these Oppressions We have Petitioned for Redress in the most

<sup>26</sup> See id.

<sup>27</sup> See The Thomas Jefferson Papers Series 1: General Correspondence, 1651-1827 (The Danbury Baptist Association's letter to Thomas Jefferson, October 7, 1801).

<sup>28</sup> See id.

<sup>&</sup>lt;sup>29</sup> See Blackstone, William, Sir., Commentaries on the Laws of England (1765).

See Moodie v. The Ship Alfred, 3 U.S. 307 (1796); see also Moodie v. The Ship Phoebe Anne, 3 U.S. 319 (1796); see also Jennings v. The Brig Perseverance, 3 U.S. 336 (1797); see also Clark v. Robert Young & Co., 5 U.S. 181 (1803); see also Hooe & Co. v. Groverman, 5 U.S. 214 (1803); see also Mandeville & Jameson v. Joseph Riddle & Co., 5 U.S. 290 (1803).

During the 1700s, Americans were familiar with Sir William Blackstone's Commentaries on the Laws of England, which stated, "The right of petitioning the king, or either house of parliament, for the redress of grievances" was a "right appertaining to every individual." Blackstone, William, Sir., Commentaries on the Laws of England (1765).

humble terms: Our repeated Petitions have been answered only by repeated injury." $^{32}$ 

In simplest terms, the right to petition the government "for a redress of grievances" allows for the right to sue. When the First Amendment was newly promulgated, persons and artificial persons were allowed to petition the Supreme Court for redress.<sup>33</sup> Although the earliest cases of artificial persons involved ships and vessels, shortly thereafter the Court began to hear cases with corporate litigants.<sup>34</sup> Thus, despite the Clause's lack of acknowledgment, the right to petition was most likely recognized as applicable to both persons and artificial persons.<sup>35</sup>

Unlike the others, the Freedom of Speech and Freedom of Press Clauses provide for the most contentious debate regarding First Amendment recognition of corporate personhood.<sup>36</sup> The Constitution's text states. "Congress shall make no law...abridging the freedom of speech, or of the press." To get a full understanding of the debate regarding the Framers' intent to supply distinctive free speech and free press rights, it helps to examine the Citizens United dissenting<sup>37</sup> and concurring<sup>38</sup> opinions. The dissent contends the Framers had a much narrower conception of free speech than we have today.<sup>39</sup> As validation, Justice Stevens cites the legislative requirement for corporate charters;40 a requirement, which was indeed, burdensome.41 "Corporate sponsors would petition the legislature, and the legislature, if amenable, would issue a charter that specified the corporation's powers and purposes and 'authoritatively fixed the scope and content of corporate organization," including "the internal structure of the corporation.<sup>42</sup> Per his assessment, this process proved corporations were merely quasi-public entities, "designed to serve a special function

<sup>32</sup> See id; see also Pfander, James, E., Sovereign Immunity and the Right to Petition: Toward a First Amendment Right to Pursue Judicial Claims Against the Government, 91 NW. U. L. REV. 899, 909 & n.36 (1997).

<sup>33</sup> See Moodie v. The Ship Alfred at 307; see also Moodie v. The Ship Phoebe Anne at 319; see also Jennings at 336.

<sup>34</sup> See id; See Clark at 181; see also Hooe at 214; see also Mandeville & Jameson at 290.

<sup>35</sup> See id.

<sup>36</sup> See Citizens United at 876.

<sup>37</sup> Id at 948-51.

<sup>38</sup> Id at 925-29.

<sup>&</sup>lt;sup>39</sup> See id at 948.

<sup>40</sup> Id. at 949.

<sup>41</sup> See id.

<sup>&</sup>lt;sup>42</sup> Id. see also Jurst, The Legitimacy of the Business Corporation in the Law of the United States, 15-16 (1970) (reprint 2004).

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for the state."<sup>43</sup> Moreover, Steven postulates that corporations having First Amendment rights would have been a novelty since its activity rested solely "in a concession of the sovereign;" highlighting the Framers' overall disdain with corporations during this time.<sup>44</sup> Under this conjecture, the Framers would not have desired to provide corporations such extensive First Amendment rights as free speech and free press.<sup>45</sup>

In contrast, Justice Scalia reads the First Amendment's protection of free speech synergistically with freedom of association, interpreting it as a right for "the freedom to speak in association with other individuals, including association in the corporate form."46 He argues that this scheme is much more straightforward than the dissent's interpretation considering the Framer's "views about the 'role of corporations in society."47 In particular, history shows that the Framers allowed corporate-like organizations to enjoy this synergetic protection.<sup>48</sup> As the concurrence highlights, newspapers that modeled corporations - with traits such as outliving their founder and an ability to be bought, sold and owned by multiple people – possessed the rights to free speech and free press.<sup>49</sup> Restated, it simply means that if newspapers, having similar traits as corporations, were recognized to have First Amendment rights, then logic would require corporations to have those very same rights as well.<sup>50</sup> Furthermore, as Scalia stresses, if First Amendment protection applies to individuals who associate in national political parties, such as the Democratic and Republican National Parties, it should also apply to individuals who gather in association in a corporation.51

Taken in aggregate, it appears the Framers intended for corporations to enjoy all First Amendment protections, excluding the

<sup>43</sup> See id. (Stevens further supports his position by highlighting the famous Justice Marshall quote, "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it").

<sup>44</sup> See id. ("Thomas Jefferson famously fretted that corporations would subvert the Republic").

<sup>45</sup> See id at 948-51.

<sup>&</sup>lt;sup>46</sup> See id at 925.

<sup>47</sup> Id.

<sup>48</sup> Id at 926-27.

<sup>49</sup> Id: see also McIntyre v. Ohio Elections Comm'n, 514 U.S. 334, 660 (1995) (Thomas, J., concurring in judgment).

<sup>50</sup> See Citizens United at 926-27.

<sup>51</sup> See id at 928.

right to assemble.<sup>52</sup> The Freedom of Assembly Clause is the sole First Amendment provision explicitly limiting its protection to persons. All other clauses infer corporate personhood legitimization; from the original perception and application of religious freedom, free speech, and free press, to the judicial history of petition rights.<sup>53</sup> Save for the Freedom of Assembly Clause, the Framers most likely intended for persons and artificial persons to equally enjoy First Amendment protection.<sup>54</sup>

#### Fourth Amendment:

"The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized." <sup>55</sup>

Similar to the Freedom of Assembly Clause, the Fourth Amendment explicitly identifies its beneficiaries, stating that the protection from unreasonable searches and seizures is a "right of the people." Despite this obvious assertion, corporations have enjoyed Fourth Amendment protection for decades. In particular, following the inundation of businesses during the nineteenth century, the Court first granted this right in a 1906 case regarding the Sherman Antitrust Act. By the 1970s, the Court even referred to this corporate

As previously discussed, the Right to Assemble overtly declares persons as its protected beneficiaries and there lacks historical evidence to support any contrary deduction. Without this right, it is constitutionally valid for the government to regulate corporations that attempt to assemble together for monopolistic purposes.

<sup>53</sup> See The Thomas Jefferson Papers Series 1: General Correspondence (1651-1827); see also Blackstone, William, Sir., Commentaries on the Laws of England (1765); see also Clark at 181; see also Hooe at 214; see also Mandeville & Jameson at 290.

<sup>54</sup> See id; see also The Thomas Jefferson Papers Series 1: General Correspondence (1651·1827); see also Blackstone, William, Sir., Commentaries on the Laws of England (1765); see also Clark at 181; see also Hooe at 214.

<sup>55</sup> U.S. Const. amend. IV.

<sup>56</sup> See id.

<sup>57</sup> See G.M. Leasing Corp. v. United States, 429 U.S. 338, 353 (U.S. 1977); see also Marshall v. Barlow's, Inc., 436 U.S. 307 (1978); see also Oliver v. United States, 466 U.S. 170, 178 (1984).

<sup>58</sup> See Hale v. Henkel, 201 U.S. 43 (1906). The court further enhanced this ruling in Marshall by holding that federal inspectors needed a warrant, or corporate

personhood legitimacy as historically valid, stating there's "no doubt that proprietors of commercial premises, including corporations, have the right to conduct their business free from unreasonable official intrusion." However, in spite of its precedential longevity, there is no historical information that evidences the Framers' intent to guarantee Fourth Amendment corporate personhood. Leaving us with the conclusion that Fourth Amendment protection for corporations does not stem from our Founders; it is a judicially crafted concept emanating from the Supreme Court. 10

To date, there are several arguments in favor of this judiciallycrafted right; especially considering the breadth of precedent supporting it.<sup>62</sup> For example, one author contends, "If one focuses on the intent of the framers, it is difficult to believe that they intended to leave churches, club offices, businesses and all real property except homes and their cartilage outside the reach of the fourth amendment."63 However, is this truly a focus on the Framers' intent, or merely a speculation?<sup>64</sup> The author, like the Court, makes this assertion (or hypothesis, to be fair) without any supporting evidence; no letters from the Framers, nothing shown in the Federalist or Antifederalist papers, no particular circumstances in which Framers had evidenced supporting this view. As a matter of fact, the author's argument disregards one striking factor. The issue does not lie in which pieces of real property are excluded from the Fourth Amendment. The issue lies in which beneficiary is excluded from the Fourth Amendment – and that beneficiary is corporations. Other real property, like homes, includes locations where "the people" may be protected from illegal search and seizure; but the non-human entities themselves are not constitutionally protected. To better explicate this

permission, to conduct a safety inspection of corporate property. See Marshall at 307.

<sup>59</sup> See id at 312; see also G.M. Leasing Corp. at 353.

<sup>60</sup> See id: Federal Trade Comm'n v. American Tobacco Co., 264 U.S. 298 (1924); see also Consolidated Rendering Co. v. Vermont, 207 U.S. 541 (1908); see also Silverthorne Lumber Co. v. United States, 251 U.S. 385 (1920); see Go-Bart Co. v. United States, 282 U.S. 344 (1931); see also Oklahoma Press Pub. Co. v. Walling, 327 U.S. 186 (1946); see also Marshall at 312; see also California Bankers Assn v. Shultz, 416 U.S. 21 (1974); see also Hale at 43; see also Oliver at 178; see also Dow at 227.

<sup>61</sup> See Hale at 43.

<sup>62</sup> See Stephen A. Saltzburg, Another Victim of Illegal Narcotics: The Fourth Amendment (as Illustrated by the Open Fields Doctrine), 48 U. Pitt. L. Rev.1 (1986).

<sup>63</sup> Id. at 17.

<sup>64</sup> See id.

concept, it is necessary to assess the Amendment's beginning, which states, "The right of the *people* to be secure in *their* persons, houses, papers, and effects, against unreasonable searches and seizures." The text provides personal protection; protecting the individual and *their* personal property. Thus, the text warrants the distinctions between the individual's property and the corporation's property, and between the person and the person as a corporate representative. In both distinctions, the latter are constitutionally unprotected by the Fourth Amendment. Hence, this textual analysis shows how the Fourth Amendment is truly a bright-line rule, which has been perpetually subverted by judicial carte blanche.

#### Fifth Amendment:

"No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." 68

Since the nineteenth century, corporations have been granted Fifth Amendment protection under the Due Process, Takings, and the Double Jeopardy Clauses.<sup>69</sup>

Notwithstanding its extensive precedent, there is no case dating back to the founding era that grants Fifth Amendment rights to

<sup>65</sup> See U.S. Const. amend. IV (emphasis added).

<sup>&</sup>lt;sup>66</sup> For example, the person in *their* own home or other real property that the person owns is different from the person in a building owned by a corporation.

<sup>67</sup> Using the previous example, the person is constitutionally protected from unreasonable searches and seizures in their own home. However, the Fourth Amendment does not guarantee this same protection for a corporation's building.

<sup>68</sup> U.S. Const. amend. V.

<sup>69</sup> See Noble v. Union River Logging R. Co., 147 U.S. 165 (1893) (where a corporation was granted due process rights under the Fifth Amendment); see also Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922) (where the Court afforded the corporation protection under the Takings Clause); see also Fong Foo v. United States, 369 U.S. 141 (1962) (where the Court granted a corporation protection under the Double Jeopardy Clause).

corporations.<sup>70</sup> Therefore, it is necessary to consider the Framers' general perception of corporations and the Fifth Amendment.

Although James Madison was not a major proponent of including a Bill of Rights to the Constitution, at the behest of several states he felt obligated to propose it. In addressing the Constitutional Convention, he defended the inclusion of explicit individual rights by stressing the need to codify what had been pervasively championed.<sup>71</sup> He proclaimed,

Although I know whenever the great rights, the trial by jury, freedom of the press, or liberty of conscience, came in question in that body [the Parliament], the invasion of them is resisted by able advocates, yet their Magna Charta does not contain any one provision for the security of those rights, respecting which, the people of America are most alarmed. The freedom of the press and rights of conscience, those choicest privileges of the people, are unguarded in the British constitution.<sup>72</sup>

Excluding his recognition of liberty of conscience, the other individual rights noted were not exclusive to persons. In particular, freedom of the press was well-known to be a shared right with persons and non-persons. The Likewise, the right to petition was a joint right collectively used by persons and corporations; begetting the rational transferability of a mutually-shared right to trial by jury. However, how would we reconcile corporate personhood legitimacy with "liberty of conscience?" More importantly, how do we explain this concept when the text makes explicit references to "person" and "limb"? One could argue that if the Framers included Madison's Fifth Amendment language in the Bill of Rights, then, by default, they accepted his

In fact, the earliest Fifth Amendment case wasn't until 1833. Barron v. Mayor & City Council of Baltimore, 32 U.S. 243 (1833).

<sup>&</sup>lt;sup>71</sup> See Congressional Register, I, 423-37; see also Gazette of the U.S., 10 and 13 (June 1789); see also Gales & Seaton, Annals of Congress. The Debates and Proceedings in the Congress of the United States (1834-56).

<sup>&</sup>lt;sup>72</sup> See Gazette of the U.S., 10 and 13, June, 1789.

<sup>73</sup> See Citizens United at 926-27; see also McIntyre at 660 (Thomas, J., concurring in judgment).

<sup>&</sup>lt;sup>74</sup> If the plaintiff exercising the right to petition also has the right to a trial by jury, then persons and corporations must equally share in the right to a trial by jury just as they equally share in the right to petition the government for redress. For cases exemplifying the shared right to petition: See Moodie v. The Ship Alfred at 307; see also Moodie v. The Ship Phoebe Anne at 319; see also Jennings at 336; see also Clark at 181; see also Hooe & Co. at 214; see also Mandeville & Jameson at 290.

justification. Meaning, if the Framers intended to grant Fifth Amendment protection to the same beneficiaries as those mentioned in his justification (recipients of the rights to freedom of press and trial by jury), then this protection most likely extended to corporations, too.<sup>75</sup> Although it is an interesting consideration, the argument may be a bit of a stretch when the text refers to such human traits as *limbs*. Likewise, under this argument, corporate personhood would apply to the entire Bill of Rights proposed by James Madison, even those Amendments<sup>76</sup> with language specifically intended for persons.

Nonetheless, a textual analysis does not entirely preclude the possibility of corporate personhood legitimacy. Similar to the First Amendment, and unlike the Fourth, the Fifth Amendment has clauses which do not explicitly refer to "persons" – specifically, the due process and takings clauses. One could say that the clauses refer back to the phrase "no person," but this argument could be made about the First Amendment's religion and petition clauses as well; despite historical precedent to the contrary. Knowing that corporations existed at the time and owned property just as persons did, the Framers may have written these Clauses in such general terms to include both persons and artificial persons. In particular, since persons and artificial persons were able to seek redress regarding property disputes, it is likely that the Framers intended for both entities to enjoy procedural due process in such suits as well as just compensation for public seizures thereof.

Although it is least probable that the Framers intended for corporations to benefit from the double jeopardy clause, they most likely intended to grant rights to corporations under the due process and takings clauses.

#### Fourteenth Amendment:

Section 1: "All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United

<sup>&</sup>lt;sup>75</sup> See id; see also Citizens United at 926-27.

<sup>&</sup>lt;sup>76</sup> Such as the Second and Fourth Amendments.

<sup>&</sup>lt;sup>77</sup> See Thomas Jefferson's Letter to Danbury Association, Jan. 1, 1802, available at http://www.loc.gov/loc/lcib/9806/danpost.html (Library of Congress); see also Moodie v. The Ship Alfred at 307; see also Moodie v. The Ship Phoebe Anne at 319; see also Jennings at 336; see also Clark at 181; see also Hooe & Co. at 214; see also Mandeville & Jameson at 290.

<sup>&</sup>lt;sup>78</sup> See Moodie v. The Ship Alfred at 307; see also Moodie v. The Ship Phoebe Anne at 319; see also Jennings at 336; see also Clark at 181; see also Hooe & Co. at 214; see also Mandeville & Jameson at 290.

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States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."<sup>79</sup>

It seems almost peculiar to discuss whether the Fourteenth Amendment was originally intended to apply to corporations. Given this nation's short history, and the yesteryear nostalgia of the Civil War, most historically apt individuals would unflinchingly answer in the negative. Nevertheless, corporations have asserted their rights to Fourteenth Amendment protection on numerous occasions.<sup>80</sup>

To quell doubt, the primary purpose of the Fourteenth Amendment was to protect persons, and quite specifically, freed Blacks.<sup>81</sup> In the Supreme Court's first Fourteenth Amendment cases, Justice Miller eloquently discussed the inherent purpose of the Reconstruction Amendments.<sup>82</sup> Moreover, the Framers used direct

<sup>79</sup> U.S. Const. amend. XIV.

See Chicago Burlington and Quincy R.Co. v. Iowa, 94 U.S. 155 (1876); see also Peik v. Chicago & Northwestern R.Co., 94 U.S. 164 (1876); see also Chicago, Milwaukee & St. Paul R.Co. v. Ackley, 94 U.S. 179 (U.S. 1876); see also Winona & St. Peter R.Co. v. Blake, 94 U.S. 180 (U.S. 1876); see also Santa Clara County v. Southern Pacific R.Co. at 394; see also Minneapolis & St. Louis R.Co. v. Beckwith, 129 U.S. 26 (1889); see also Wal-Mart Stores, Inc. v. City of Turlock, 483 F. Supp. 2d 123 (Dist. 2007).

<sup>81</sup> See Graham, Howard Jay, Everyman's Constitution, State Historical Society of Wisconsin (1968); see also Slaughterhouse Cases, 83 U.S. 36 (1872).

He states, "The most cursory glance at these articles discloses a unity of purpose, when taken in connection with the history of the times, which cannot fail to have an important bearing on any question of doubt concerning their true meaning. Nor can such doubts, when any reasonably exist, be safely and rationally solved without a reference to that history, for in it is found the occasion and the necessity for recurring again to the great source of power in this country, the people of the States, for additional guarantees of human rights, additional powers to the Federal government; additional restraints upon those of the States. Fortunately, that history is fresh within the memory of us all, and its leading features, as they bear upon the matter before us, free from doubt. We repeat, then, in the light of this recapitulation of events, almost too recent to be called history, but which are familiar to us all, and on the most casual examination of the language of these amendments, no one can fail to be impressed with the one pervading purpose found in them all, lying at the foundation of each, and without which none of them would have been even suggested; we mean the freedom of the slave race, the security and firm establishment of that freedom, and the protection of the newly made freeman and citizen from the oppressions of those who had formerly exercised unlimited dominion over him." Id.

language stating this purpose when proposing terms for the Amendment's drafting.83 Representative Thaddeus Stevens of Pennsylvania suggested the statement, "All laws, state or national, shall operate impartially and equally on all persons without regard to race or color."84 Although subsequent congressional statutes85 included additional protected classes (such as religion, gender, and national origin), those statutes do not conflict with the intent of the Amendment because they relate to the equal treatment of persons, including Blacks. In contrast, it would be rather difficult to align the Fourteenth Amendment's general purpose with corporate personhood legitimacy.86 For example, a statute requiring equal protection for corporations as citizens under the Fourteenth Amendment would be inapplicable to the original intent of the Framers because it has no remote relationship to the intended beneficiaries.87 Therefore, despite the immense fervor of corporate lawyers to prove otherwise, corporations were never intended to have equal status as persons under the Fourteenth Amendment.88

### II. The Implications of Corporate Personhood

It is highly probable that corporate personhood was an intended recognition in a majority of the First and Fifth Amendment clauses; yet, it is also probable that this concept was not originally intended in the Fourth and Fourteenth Amendments. So As shown earlier, various founding era circumstances, and even documents, substantiate the likelihood that several First and Fifth Amendment Clauses were meant to recognize persons and artificial persons. While a general assessment of the Fourth and Fourteenth Amendments' text as well as

<sup>83</sup> See Kendrick, B., The Journal of the Joint Committee of Fifteen on Reconstruction 46 (1914).

<sup>84</sup> See id.

<sup>&</sup>lt;sup>85</sup> Civil Rights Act of 1964, Voting Rights Act of 1965, Civil Rights Act of 1968 et al.

<sup>86</sup> See Slaughterhouse Cases at 36.

<sup>87</sup> See id.

<sup>88</sup> See id.

<sup>89</sup> See The Thomas Jefferson Papers Series 1: General Correspondence, 1651-1827 (The Danbury Baptist Association's letter to Thomas Jefferson, October 7, 1801); see also Moodie v. The Ship Phoebe Anne at 319; see also Jennings at 336; see also Clark at 181; see also Hooe & Co. at 214; see also Mandeville & Jameson at 290; see also Hale at 43; see also Graham, Howard Jay, Everyman's Constitution, State Historical Society of Wisconsin (1968); see also Slaughterhouse Cases, 83 U.S. 36 (1872).

<sup>90</sup> See Citizens United at 925-930 (Scalia concurrence); see also Hooe & Co. at 214 (where an artificial person was able to bring suit to redress their grievances).

the general purpose behind the latter demonstrates that the corporate personhood concept was not intended to apply to these Amendments.<sup>91</sup> What this means is that although the Framers did not intend for a general corporate personhood legitimacy, they also did not completely disregard the concept in every Amendment.

Cases like Citizens United and First National Bank of Boston v. Bellotti create a great forum for the corporate personhood debate. 92
The passion for both proponents and dissenters rises up and they expound vast rhetoric to persuade their impervious adversaries in conceding to their viewpoints; but a concession rarely occurs. Each side tends to be all or none. What is interesting, however, is that our nation is far more moderate than its constituency. 93 Favoring a polity in equipoise rather than extremism. Therefore, with concepts such as corporate personhood, instead of being completely for or against it, it is best to consider its overall implications. Determining the beneficial and detrimental traits and implementing a cost-benefit analysis thereafter.

#### A. First Amendment

To start, there are many philosophical and economical concerns that arise when supplying corporations with equal First Amendment protection. With religious freedom, corporations have the power to manipulate the masses for profit, but they also have the ability to provide religious products in a convenient, frugal manner. Moreover, granting corporations the right to assemble would create greater uniformity and idea-sharing, yet it would result in oligopolistic consequences. Likewise, although corporate petition rights can prevent overly-intrusive government regulations, it can also lead to judicial corruption. And lastly, freedom of speech and press allow corporations to have a say in policies directly affecting them, but they also increase the likelihood of political malfeasance. These are just a few factors to consider in a cost-benefit analysis of corporate personhood and First Amendment protection.

With the Religion Clause, opponents of corporate personhood may object to corporations having this right because of their

<sup>91</sup> See Slaughterhouse Cases, 83 U.S. 36 (1872).

<sup>92</sup> See Citizens United at 876; see also Bellotti, 433 U.S. 765 (1978); see also Austin v. Mich. State Chamber of Commerce, 494 U.S. 652 (1990).

<sup>93</sup> Consider Thomas Jefferson and John Hamilton. Both prominent framers with polarizing ideals for the country; Hamilton being a staunch federalist and Jefferson being an agrarian anti-federalist. Our nation is a fascinating combination of both these ideals.

incorporeal attachment to the subject. Since people have such ardent feelings about religion, they believe that religious value becomes denigrated when shared with such artificial entities as corporations. However, emotional feelings aside, there are several benefits in allowing corporations to enjoy religious freedom. For example. corporations provide religious product to the masses, making access to such material convenient and inexpensive. Companies are able to mass produce religious literature and paraphernalia, and even ship items from foreign religious locations94 at a much lower price than individual sellers. To imagine a different situation where religious items are purchased solely from individuals requires us to fathom a society with only small business owners; the prices would be enormously inflated. The difference in price would be comparable to purchasing a sandwich from a local deli versus Subway. Furthermore, corporations provide a direct financial benefit when exercising religious freedom. Depending on the cause and amount, corporations are able to sponsor religious activities and associations. In some cases, corporations have even donated money to develop property for struggling churches.95 These direct donations paired with the convenience and frugality of mass produced religious items are all positive consequences of corporate religious freedom.

Another important factor to consider is the negative effects of prohibiting corporate personhood under the religion clause. Specifically, corporations are within the category of artificial persons. By default, so are other associations and organizations, such as churches. For If corporations are not allowed to participate in and contribute to religious activities, then neither are other organizations and associations, and neither are churches. People would be able to freely gather for religious participation, but they would not be able to enjoy the benefits of a church, as a non-profit organization. In essence, denying religious freedom to corporations is a specious ideal that would have a direct impact on the very organizations where individuals gather to exercise their constitutional right.

In contrast, the right to assemble deserves more caution. When our Founders provided for the right to assemble, it was not only a reaction to British oppression, but it was also an effort to inscribe into

<sup>94</sup> I.e. Sand from Jerusalem.

<sup>95</sup> See Roberts, Terry, "Church Gets a Bailout," The Weekend Telegram (January 2, 2010) (A local development corporation makes a generous donation to assist a Roman Catholic Church in developing their property to ensure continued operation).

<sup>&</sup>lt;sup>96</sup> For tax purposes, churches are non-profit organizations.

<sup>97</sup> Such benefits would include receiving and providing donations.

law the very activity that allowed them to collectively draft the Constitution. Essentially, this right allowed the Framers to create a document that has had immense societal influence. It is exemplary of the power of assembly and it is that realization alone that justifies our need to carefully monitor the right.

Nevertheless, supplying corporations with the right to assemble has its benefits. For starters, in its less harmful form, corporate assembly is nothing more than a convention of like industries. A convention provides for a forum that promotes industry innovation, where companies are able to gather and discuss resolutions to industry wide technological and economic concerns. 98 For example, in recent times, companies have come together to discuss the best solutions to overcome the effects of piracy.<sup>99</sup> As a result, broadcasters began streaming current television episodes on their official websites. interspliced with fifteen to thirty second advertisements. 100 Not only did this provide the companies with a new source of ad revenue, but it provided consumers with the benefit of watching their favorite television shows at anytime for no added cost. Even giving them the ability to time shift for convenience; pausing, rewinding, and fastforwarding at will. Such forums are not only important for corporations, but it is necessary for other artificial entities as well. This would include the American Medical Association, the American Bar Association, the American Red Cross, etc. Like religious freedom, prohibiting assembly rights for corporations, could have negative ramifications on other artificial entities.

On the contrary, there are several reasons to support limiting corporate assembly rights. In particular, to protect consumers and even the economy, the government has to control the oligopolistic effects of certain combined corporations. Providing corporations with equal rights to assemble allows them to misuse the right in order to

Onsider media conventions where music corporations and television companies gather to discuss a transition into new media. Specifically, how to handle piracy and the possibilities of online ad revenue. This type of info-sharing trickles down to benefit consumers.

<sup>99</sup> See www.natpe.org. NATPE stands for the National Association of Television Program Executives. The association has an annual conference in which television industry professionals gather to network and attend several forums. In 2008, NBC President and CEO Jeff Zucker hosted a forum called "Leading Global Programming, Advertising, and New Media" where he discussed business model reformation for broadcasters to acclimate to the rise of digital media. This type of info-sharing trickles down to benefit consumers.

See id (Jeff Zucker discusses the plan to begin online streaming of NBC television shows); see also www.nbc.com (where there are full TV episodes that have been uploaded onto the site).

circumvent anti-trust laws. Like monopolies, oligopolies may have staggering effects on the consumer market with price gouging and decreased efficiency. Therefore, it is important for them to be regulated to decrease societal harm.

Like individuals, it is also overwhelmingly important for corporations to be able to petition the government for a redress of grievances. With this right, corporations may protect themselves from hostile intrusion from other corporations, people, and of course, the government. A company may seek redress regarding collusive politicians attempting to appease their constituency through overregulation. Moreover, shareholders are able to bring derivative actions on behalf of corporations to redress the harm caused by fraudulent or grossly negligent board executives. 101

On the other hand, one could argue that allowing corporations to have an uninhibited right to petition can corrupt the political process. Proponents of this view point to the political manipulation by lobbyists. <sup>102</sup> They believe that curtailing corporations' right to petition may decrease their propensity to bribe political officials. A view that is widely-held by many members of Congress. <sup>103</sup> Thus, although it is undoubtedly vital for corporations to have a right to sue, it is also important to reduce corrupt lobbying efforts by regulating their general right to petition.

Likewise, providing corporations with freedom of speech has its benefits and detriments. Broken up into two different categories, political and commercial, there are many people who feel corporations should be solely limited to the latter. Before discussing the pros and cons of corporate personhood recognition for either, it is worth considering one valid inquiry – with corporations, what is the difference between political and commercial speech? Commercial speech is generally known as speech made to generate profit; like an advertisement. <sup>104</sup> Political speech is a form of expressing one's opinion about political views. Within the last few decades, the Supreme Court has declared political spending as a form of political speech, which theoretically makes sense. <sup>105</sup> However, the crux of the issue lies in the purpose of a corporation. Essentially, a corporation's goal is to

<sup>101</sup> See Rule 16(b) of the Securities Exchange Act of 1934.

See Schmidt, Susan and Grimaldi, James, "Abramoff Pleads Guilty to 3 Counts," The Washington Post (January 4, 2006) (the article discusses former lobbyist Jack Abramoff's conspiracy to bribe public officials).

See The Executive Branch Reform Act, H.R. 984 (a bill that would require executive branch members to report any significant contact from private parties).

<sup>&</sup>lt;sup>104</sup> See Valentine v. Chrestensen, 316 U.S. 52 (1942).

<sup>105</sup> See Buckley v. Valeo, 424 U.S. 1 (1976).

maximize profits, whether for its own advancement or shareholders' benefits. Whenever it transacts, whenever it "speaks," and whenever it spends, it should do so to further its goal of maximizing profits. If a corporation is expending funds to a political candidate or campaign, what reason would they have for doing so? In essence, their ultimate goal is to somehow translate these expenditures into future gains — whether it is to support policies or candidates to push an agenda that will result in potential profits. Accordingly, the government should be allowed to regulate a company's "political" speech in the same manner it regulates its commercial speech.

Nevertheless, since corporations now have and proclaim rights to commercial and political speech, it is necessary to do a cost-benefit analysis for both. Having a constitutional right to commercial speech allows corporations to represent their companies by separating themselves from competition. Not only does commercial speech give corporations a competitive advantage, but the right allows them to increase profits and further the ideals of our capitalist structure. Essentially, commercial speech is a required function for a corporation's ability to grow.

Similarly, political speech provides a similar support. The right gives corporations the ability to have a voice in the political process. It ensures that companies are not mere innocent observers in situations where government policies and candidate agendas have direct impacts on the company's economic future.

Despite the advantages this speech supplies to companies, many people do not think they outweigh the potential societal harm and distortion. On the one hand, dissenters have a logical fear of being overpowered by corporations. They imagine situations where the voices of the people would be subdued by the voices of the corporation through unrestrained corporate political spending. <sup>106</sup> In addition, they envision massive corruption and immense political influence. <sup>107</sup> They foresee their representatives being purchased by the highest contributing corporation. Beyond these political concerns, many are

<sup>106</sup> President Grover Cleveland stated, "As we view the achievements of aggregated capital, we discover the existence of trusts, combinations, and monopolies, while the citizen is struggling far in the rear or is trampled to death beneath an iron heel. Corporations, which should be the carefully restrained creatures of the law and the servants of the people, are fast becoming the people's masters."

Addressing Congress, President Jackson declared, "...the question is distinctly presented whether the people of the United States are to govern through representatives chosen by their unbiased suffrages or whether the money and power of a great corporation are to be secretly exerted to influence their judgment and control their decisions."

worried about the distortive effect. <sup>108</sup> They argue that shareholders provide capital to corporations who in turn disburse funds to political candidates and campaigns. <sup>109</sup> Meaning that shareholders would spend money on candidates they do not support, thus, resulting in distortion. <sup>110</sup> Although these are very real concerns, reducing or eliminating corporate political speech could have grave effects on the rights of other artificial entities, such as unions, associations, and organizations.

#### B. Fourth Amendment

Like individuals, companies deserve Fourth Amendment protection. Security from unreasonable searches and seizures is the equivalent to a necessary privacy right for persons and corporations. Requiring warrants and probable cause prevents intrusive government enforcement. Otherwise people and companies would have a lurking fear that at any moment their privacy could be infringed upon. Moreover, it would further the fear that law enforcement is capable of terrorizing particular individuals or corporations and ransacking their property until they locate incriminating items. Although there is a real concern that this right allows corporations to get away with heinous crimes due to mere technicalities, this worry is no different than with individual criminals. Thus, if we provide this right to individuals, corporations should also have the freedom to transact without the fear of unreasonable government intrusion.

#### C. Fifth Amendment

Supplying corporations with Fifth Amendment rights provides for due process and takings clause protection. Under the due process clause, it is only logical that, as litigants, corporations can have fair and adequate judicial proceedings. This would include unbiased triers of fact and reasonable punitive damages. 111 Our Constitution would allow for no less. Procedural due process is the backbone of our impartial justice system and is something provided for all litigants, despite identification. In contrast, the necessity for substantive due process rights is not as dire. The subjectivity of this protection gives

<sup>108</sup> See Citizens United at 876, Brief for Senator John McCain et al. as Amici Curiae, 13·15.

<sup>109</sup> See id, Supp. Brief for Appellee, 5-9.

<sup>110</sup> See id.

<sup>111</sup> See BMW v. Gore, 517 U.S. 559 (1996).

companies the ability to argue for various unenumerated rights not specifically intended for corporations. Providing corporations with such rights would, indeed, be a "shock to the conscience." 113

Like procedural due process, takings clause protection is a pragmatic right for corporations to enjoy. It prevents the government from unreasonably seizing corporate property without just compensation. This is important because, like individuals, corporations invest a lot of money into their property. Therefore, it is only just to receive a fair price for the property and seizures should only be for public good. On the other side of this argument, many people believe this protection makes it difficult for the government to purchase property in an effort to curb societal and environmental harms. 114 One example of this concern is a California case where the government purchased land (located on sand dunes) from a corporation for more than the company's original purchase price. 115 The corporation subsequently sued under the takings clause and was awarded \$1.45 million of taxpayers' money. 116 Despite the government's interest in protecting the environment, because of the corporation proclaimed takings clause rights, the government was required to pay almost five times the company's purchase price. 117 Unlike an individual, the corporation was able to argue that managing a business on the property would have resulted in exponentially more than the purchase price of the land. 118 Contrasted with a situation where an individual would not have received a speculative amount because of future "viable economic interest;" the amount the government originally paid would have most likely been deemed sufficient. 119 Therefore, despite its practical uses, takings clause protection for corporation would provide them with a greater advantage than individuals using the same right.

#### D. Fourteenth Amendment

They could even revert back to the *Griswold* era of penumbra justifications; arguing that random unenumerated rights are necessary for them to exercise the enumerated ones. *See Griswold v. Connecticut*, 381 U.S. 479 (1965).

<sup>113</sup> See Rochin v. California, 342 U.S. 165 (1952).

<sup>114</sup> See City of Monterey v. Del Monte Dunes, 526 U.S. 687 (1986)

<sup>115</sup> Id. at 694-700.

<sup>116</sup> Id. at 701, 723.

<sup>117</sup> See id.

<sup>118</sup> See id. at 700-701.

<sup>119</sup> See id.

The arguments for due process would be the same for the Fourteenth amendment as they are for the Fifth Amendment. Procedural due process is a practical necessity, while substantive due process provides corporations with creative freedom to argue for random unenumerated rights. Therefore, the major consideration for the Fourteenth Amendment would be the benefits and detriment of providing corporate personhood legitimacy under the equal protection clause. With the most innocuous implication, such rights would only require equal protection amongst fellow corporations. At its worst, it would mean equal protection for corporations as persons. The benefit of equal protection between fellow corporations would mean that a company could effectively prevent political favoritism of other companies stemming from their financial contributions. Arguing its Fourteenth Amendment equal protection rights, corporations could create a counterpoise for the inevitable imbalance likely to occur with loosely regulated political spending. 120 However, while this situation seems ideal, corporate personhood recognition would probably mean equality between corporations and persons. The difficulty with this identification is that the benefits and harms of the person would be pitted against the benefits and harms of the corporation. At its extreme, this would mean protecting the economic interests of corporations as fervently as protecting the interests of persons. Thus, a government's compelling interest in regulating a corporation to economically benefit a community of people would fail if it would resultantly hinder the economic interests of the corporation. Therefore, while procedural due process would be a beneficial right for corporations, substantive due process and equal protection rights may prove more detrimental to society.

### CONCLUSION

It is probable that the Framers did not intend to provide corporate personhood legitimacy for the Fourth and Fourteenth Amendments: however, a cost-benefit analysis may show that there is still a valid reason to allow corporations to exercise certain rights within these Amendments. Accordingly, the same analysis may prove otherwise with Amendments for which the Framers intended to provide corporate personhood legitimacy. Under the First Amendment, save for the right to assemble, the Framers most likely intended for corporations to equally enjoy its protections (religious freedom, the right to petition, and free speech and free press). The

<sup>120</sup> See Citizens United at 876.

cost-benefit analysis shows that adhering to this intent would be more beneficial than detrimental to society. 121 On the contrary, the Framers did not intend to provide corporations with Fourth Amendment protection, yet allowing corporations to prevent intrusive government enforcement outweighs the possibility that corporations would evade punishment due to technicalities. Hence, despite the lack of original intent, Fourth Amendment corporate personhood may be beneficial. With the Fifth Amendment, the Framers most likely intended for corporations to be protected by the Due Process and Takings Clauses. Likewise, aside from granting substantive due process rights, the benefits of impartial proceedings and protecting corporate property investments prevail over the government's potential difficulty to seize property for environmental purposes. 122 Thus, to a limited extent, it would be efficient to allow Fifth Amendment corporate personhood. In contrast, originalism proves the Framers never intended to provide corporate personhood legitimacy in the Fourteenth Amendment, and similarly, the benefits of supplying the protection do not outweigh the detriments of preventing it. 123 Therefore, Fourteenth Amendment corporate personhood should not exist because it was neither originally intended by the Framers, nor is it beneficial to society.

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<sup>121</sup> Under the cost-benefit analysis, the benefits of mass produced religious items and the negative impact of prohibiting this right on religious associations and organizations (such as churches) outweighs the detriment of devaluing religion due to its association with corporations. Although it was not intended for corporations to enjoy, the benefit of information sharing is equal to the detriments of oligopolistic consequences; or at the very least, not significantly outweighed by the latter. Providing corporations with a right to petition the government for grievances (i.e. shareholder derivative actions) is equal to or greater than the possibility of lobby corruption. Similarly, granting corporations the right to commercial speech and political speech is equal to or greater than prohibiting this right due to potential political influence and distortion. In particular, commercial speech provides for economic growth and an ability to exercise political speech allows corporations to contribute to political discussion that directly impacts their companies.

<sup>122</sup> Substantive due process is not beneficial because it would allow companies to make unwarranted claims for arbitrary unenumerated rights.

<sup>123</sup> The harm in the possibility of equal consideration of corporate and individual economic interests outweighs the low probability that corporations would use this right to expose political favoritism from corporate bribery.

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### RUTGERS BUSINESS LAW JOURNAL

**CHARLES PALL** 

# The Impact of President Obama's Fiscal Regulatory Reform Proposals on the Life Insurance Industry

ABSTRACT. After the financial instability of 2008, the Obama administration proposed a series of significant changes to the financial regulatory system. This note examines how the proposed reforms would impact financial-services companies focused on insurance, retirement, and annuity products. The note considers the possible impact on prudential capital requirements, non-bank activity limits, and consumer protection regulations.

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## THE IMPACT OF PRESIDENT OBAMA'S FISCAL REGULATORY REFORM PROPOSALS ON THE LIFE INSURANCE INDUSTRY

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### INTRODUCTION

The financial crisis that saw the collapse or liquidation of long-time financial industry cornerstones such as Lehman Brothers, Merrill Lynch, Bear Stearns, and American International Group ("AIG") has the potential to spurn long-term legal and regulatory reforms. While much media attention has focused on the Administration's efforts to reform the U.S. health care system, President Obama has proposed significant changes to the regulatory system that failed to prevent the instabilities of 2008. This note examines how the reforms proposed by the White House policy paper<sup>1</sup>, Financial Regulatory Reform – A New Foundation<sup>2</sup> (the "White Paper"), would impact the central business requirements of major financial-services companies focused on insurance, retirement, and annuity products ("insurance companies" 3), if they were implemented as proposed.<sup>4</sup>

In addition to the Administration's White Paper, a number of other reform plans have been proposed, including two reports from the Group of Thirty, a report from the National Association of Insurance Commissioners, the U.S. Treasury Department's Blueprint, and a working draft of reforms proposed by U.S. Senator Chris Dodd. See generally Lawrence A. Cunningham and David Zaring, The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response, 78 GEO. WASH. L. REV. 39; Renee M. Jones, Back to Basics: Why Financial Regulatory Overhaul Is Overrated, 4 Entrepreneurial. Bus. L.J. 391 (2010); Saule Omarova & Adam Feibelman, Risks, Rules, and Institutions: A Process for Reforming Financial Regulation, 39 U. Mem. L. Rev. 881 (2009).

U.S. DEP'T OF THE TREASURY, Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation (2009), available at http://www.financialstability.gov/docs/regs/FinalReport\_web.pdf [hereinafter "White Paper"].

The impact of financial regulatory reform on the financial services industry, as a whole, is more substantial, and is beyond the scope of this article. For this note,

# THE IMPACT OF PRESIDENT OBAMA'S FISCAL REGULATORY REFORM PROPOSALS ON THE LIFE INSURANCE INDUSTRY

# I. BACKGROUND OF THE INSURANCE REGULATORY SYSTEM

major financial services companies that have a life insurance and annuity business lines ("insurance companies") has been defined as the fourteen companies that were either top ten in life insurance underwriting or annuity considerations as calculated by the National Association of Insurance Commissioners at the end of CY 2008. This list includes: Aegon U.S. Holding Group, American Intl Group, AXA Insurance Group, Hartford Fire & Casualty Group, ING America Insurance Holding Group, Jackson National Group, John Hancock Group, Lincoln National Group, Mass Mutual Life Insurance Group, Metropolitan Group, New York Life Group, Northwestern Mutual Group, Prudential of America Group, TIAA Family Group. National Association of Insurance Commissioners, Life and Fraternal Insurance Industry 2008 Top 25 Companies by Countrywide Premium, available at http://www.naic.org/document s/research\_home\_life\_fraternal.pdf.

In addition to broad efforts to reform large segments of the financial industry at once, the National Association of Insurance Commissioners is exploring insurance-centric reforms through its Solvency Modernization Initiative ("SMI"). NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, WHAT IS THE SOLVENCY MODERNIZATION INITIATIVE (SMI) (2009), http://www.naic.org/documents/committees\_ex\_isftf\_smi\_overview.pdf ("The SMI is a critical self-examination of the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation.")

While the history of the U.S. insurance industry begins at least as early as 1752,<sup>5</sup> the Supreme Court did not narrow the role of the federal government as regulator until the 1865 ruling in *Paul v. Virginia*, in which the Court held federal regulation a violation of the commerce clause. <sup>6</sup> States were encouraged by the 1865 opinion to implement a "fairly comprehensive" state-centric regulatory framework. By the time the Court reversed itself in 1944,<sup>8</sup> state regulation was sufficiently established to trigger the U.S. Congress to enact the McCarran-Ferguson Act,<sup>9</sup> requiring that federal insurance

<sup>&</sup>quot;Benjamin Franklin created Philadelphia Contributionship for Insurance of Houses From Loss by Fire in 1752, which was first mutual insurer in North America." Gregory N. Racz, Note, No Longer Your Piece Of The Rock: The Silent Reorganization Of Mutual Life Insurance Firms, 73 N.Y.U.L. Rev. 999, 999 n.2 (1998).

Paul v. Virginia, 75 U.S. (8 Wall) 168, 183 (1869), overruled by U.S. v. South-Eastern Underwriters Assoc., 322 U.S. 533, 547 (1944) (holding "[i]ssuing a policy of insurance is not a transaction of commerce").

<sup>&</sup>lt;sup>7</sup> Susan Randall, Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners, 26 FLA. St. U. L. Rev. 625, 632 (1999). (footnote omitted) ("By the 1940s, state regulation was fairly comprehensive, with the exception of rate regulation . . . .").

<sup>&</sup>lt;sup>8</sup> U.S. v. South-Eastern Underwriters Assoc., 322 U.S. 533, 547 (1944), superseded by statute, McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (2009)) (holding that "a nationwide business is not deprived of its interstate character merely because it is built upon sales contracts which are local in nature").

<sup>9</sup> See Debevoise & Plimpton LLP, Placing Proposals for Federal Regulation of Insurance in Context: A Brief History of Insurance Regulation in the United States, FINANCIAL INSTITUTIONS REPORT, Spring 2008, at 3, 4, available at http://www.debevoise.com/files/Publication/25b76819-f9ff-427c-93e6-00994ad277

statutes explicitly identify themselves as preemptive.<sup>10</sup> Since the passage of the McCarran-Ferguson Act, the Federal government has incrementally increased its participation in the insurance industry by enacting the Employee Retirement Income Security Act<sup>11</sup> ("ERISA") and by assisting the underwriting of high-risk insurance programs.<sup>12</sup> Despite these federal actions, the insurance business remained largely state regulated.<sup>13</sup>

The insurance industry also remained largely independent from other financial services businesses due to Glass-Steagall Act<sup>14</sup>

ec/Presentation/PublicationAttachment/eafb51df-4760-4e4d-a449-0132e8e7d40b /FIRSpring2008.pdf [hereinafter Debevoise Spring 2008]. McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (2009)) ("The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.").

- U.S. Dept. of Treasury v. Fabe, 508 U.S. 491, 507 (1993) (reaffirming that federal preemption of state law under the McCarran-Ferguson Act must be explicit).
- Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 U.S.C. and 29 U.S.C.).
- Debevoise Spring 2008, *supra* note 9, at 4 (Some programs sponsored "includ[e] flood insurance crop insurance, terrorism insurance, social security, deposit insurance, and other forms of insurance.")
- Randall, supra note 7, at 632-43.
- Glass-Steagall §§ 16, 20-21, and 32 limit, or preclude, securities transactions by nationally chartered banks. The Banking (Glass-Steagall) Act of 1933, ch. 89, 48 Stat. 162, 184-85, 188-89, 194, repealed by Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

prohibitions on the combination of bank holding and securities companies, and Bank Holding Company Act<sup>15</sup> prohibitions on the affiliation between banking and insurance companies. <sup>16</sup> However, these limitations were incrementally weakened by a series of statutory interpretations <sup>17</sup> and Supreme Court decisions <sup>18</sup>. In 1999, both the Glass-Steagall Act <sup>19</sup> and Bank Holding Act <sup>20</sup> industry-separating provisions were repealed or amended by the Gramm-Leach-Bliley Financial Services Act <sup>21</sup> ("GLB Act"). The GLB Act allowed insurance

Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133, 137 (codified as amended at 12 U.S.C. §§ 1841 et seq.). Insurance underwriting was prohibited; however, the Federal Reserve did permit some Midwestern banks, which had traditional done so, to act as agents for some insurance products. Thomas E. Wilson, Separation Between Banking and Commerce Under the Bank Holding Company Act – A Statutory Objective Under Attack, 33 CATH. U.L. REV. 163, 167 (1983).

<sup>16</sup> Debevoise Spring 2008, supra note 9, at 4.

Saule T. Omarova, The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking," 63 U. MIAMI L. REV 1041, 1051-53 (2009) (explaining that the Office of Currency Control was a strong proponent of interpreting BHA provisions "broadly").

Id. at 1052-53 (citing NationsBank of North Carolina v. Variable Annuity Life Ins. Co. (VALIC) 513 U.S. 251 (1995)).

Glass-Steagall Act § 20 was explicitly repealed by the Gramm-Leach-Bliley Act § 101(a). Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999) (codified at 12 U.S.C. 377).

The activity restrictions of the Bank Holding Company Act of 1956 were amended in the Gramm-Leach-Bliley Act §§ 102-103. Gramm-Leach-Bliley Act §§ 102-103.

<sup>&</sup>lt;sup>21</sup> Gramm-Leach-Bliley Act §§ 101 · 103.

companies to enter what were traditionally banking and securities businesses, <sup>22</sup> but left regulation divided between the states and various federal agencies with no single regulator responsible for the entirety of a company. <sup>23</sup>

# II. IMPACT OF THE EXISTING REGULATORY SYSTEM ON THE 2008 FINANCIAL CRISIS

This divided regulatory framework is being examined in light of the liquidity crisis which developed in 2008. The divided responsibilities left some financial services companies with insurance, banking, and securities businesses operating in areas of regulatory gap or overlap.<sup>24</sup> AIG, in particular, was identified as exploiting the regulatory gap between state insurance regulators, federal securities

<sup>&</sup>quot;Specifically, the GLB Act permits a bank holding company... to elect to become [a financial holding company, which are] permit[ed] to engage in, or affiliate with a company engaged in, any activity that has been determined to be financial in nature or incidental to a financial activity under the Act [including] securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking." BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT TO THE CONGRESS ON FINANCIAL HOLDING COMPANIES UNDER THE GRAMM-LEACH-BLILEY ACT 1 (2003), available at http://www.federalreserve.gov/boarddocs/rptcongress/glbarptcongress.pdf [hereinafter Report on GLB Act].

<sup>&</sup>lt;sup>23</sup> Cunningham et al, supra note 1, at 74 ("The 2008 crisis certainly looks like a testimonial for the proposition that the fragmented, industry-by-industry, regulatory model is outdated and leaves regulatory gaps that must be closed."). But see id. at 101 ("A potentially appealing result of this fragmentation of authority is a palette of options for participants in financial markets [and] a close fit between regulatory expertise and the targeted firms.")

<sup>24</sup> Id.

regulators, and federal thrift regulators.<sup>25</sup> In response to concerns that the patchwork left some aspects of the financial services industry subject to a critical lack of regulation,<sup>26</sup> on June 17, 2009, President Obama's administration released the White Paper.<sup>27</sup> The White Paper proposes new statutory regulations, agencies, and goals.<sup>28</sup> In the month that followed the release of the White Paper, the administration released fourteen draft bills<sup>29</sup> to implement the White Paper goals.<sup>30</sup>

<sup>25 &</sup>quot;AIG highlighted gaps in our insurance regulatory system,' said Leigh Ann Pusey, president of the American Insurance Association, which has pushed for federal oversight for a decade." Erik Holm, Obama's Insurance Proposal May Grab Power from States, Bloomberg.com, June 19, 2009, http://www.bloomberg.com/apps/news?pid=20601208&sid=abiYc037lTNI "We had 20 different states with authority over 72 insurance subsidiaries of AIG just in this country." Id.

Martin N. Baily, Strengthening and Streamlining Prudential Bank Supervision, Initiative on Business and Public Policy at Brookings (The Brookings Institution, Washington, D.C.), Aug. 6, 2009, at 13, available at http://www.brookings.edu/~/media/Files/rc/papers/2009/0806\_streamlining\_baily/0806%20Baily.pdf.

President's Remarks on Financial Regulatory Reform, 2009 Daily Comp. Pres. Doc. 00474, pg. 1 (June 17, 2009), available at http://www.gpo.gov/fdsys/pkg/DCP D-200900474/html/DCPD-200900474.htm.

<sup>28</sup> See id.

The Obama Administration released the draft legislation through the Department of the Treasury; however, the plan was not formally introduced to Congress and thus was not assigned U.S. House or Senate resolution numbers. Consequently, this note will identify the fourteen documents as "executive proposed legislation." Administration proposed legislation that has been formally introduced to the House or Senate will be identified by the resolution number when appropriate. All fourteen documents are available at the Treasury Department's Financial Stability website. FinancialStability.gov, http://financialstability.gov/roadtostability/RRread.html (last visited May. 1, 2010).

The proposed legislation broadens previous unrenacted regulatory reform efforts.<sup>31</sup> While the proposed legislation maintains the principles of the McCarran-Ferguson Act by identifying insurance products for differing regulation,<sup>32</sup> the stated intent of the White Paper

Press Release, U.S. Dep't of Treasury, Administration's Regulatory Reform Agenda Moves Forward: Legislation for Strengthening Consumer Protection Delivered to Capitol Hill (June 30, 2009), available at http://www.ustreas.gov/press/releases/tg229.htm.

For example, the U.S. Dep't Treasury plan which was formally announced almost concurrent with the Bear Stearns collapse in March, 2008 proposed extensive reform of the financial regulatory system, but did not propose the additional consumer protections that are proposed by the White Paper. U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), available at http://www.treas.gov/press/releases/reports/Blueprint.pdf.

E.g. Exec. Prop. Legislation, Title X – Consumer Financial Protection Act of 2009 (proposed 2009), § 1002(18)(O), available at http://www.financialstability.gov/docs/CFPA-Act.pdf [hereinafter Title X] (stating that "the [CFP] Agency shall not define engaging in the business of insurance as a financial activity (other than with respect to credit insurance, mortgage insurance, or title insurance...)" A substantially similar bill, with the same insurance restriction language, has been introduced to the House of Representatives. Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. (2009). The similarly named Financial Product Safety Commission Act of 2009 does not contain this language, but still explicitly excludes the insurance industry from CFPA regulation. Financial Product Safety Commission Act of 2009, H.R. 1705, 111th Cong. § 5 (c) (the [] 'McCarran-Ferguson Act' [] remains the law of the United States.")

is to "close loopholes" 33 and "[e]nhance [o]versight of the [i]nsurance [s]ector." 34

#### III. DISCUSSION

The White Paper defines five primary policy goals of the administration's reform efforts: (1) "promote robust supervision and regulation of financial firms;" (2) "establish comprehensive regulation of financial markets;" (3) "protect consumers and investors from financial abuse;" (4) provide the government with the tools it needs to manage financial crises;" and (5) "raise international regulatory standards and improve international<sup>35</sup> cooperation." Enacting laws or regulations that achieves these goals would result in changes to the insurance industry<sup>37</sup> that could be grouped into two broad categories:

<sup>&</sup>lt;sup>33</sup> Speaking explicitly of closing the Bank Holding Company Act exemption for thrift holding companies and later citing AIG, discussed *infra* III.B.2. White Paper, *supra* note 2, at 34.

White Paper, supra note 2, at 39.

The ability of the United States to rationalize its regulatory requirements with international requirements has been hampered by the diversity of pre-existing regulation in the several states. Elizabeth F. Brown, *The Development of International Norms For Insurance Regulation*, 34 BROOKLYN J. INT'L L. 953, 987-88 (2009).

White Paper, supra note 2, at 3-4.

In addition, the White Paper identifies six principles for reform of the insurance industry: (1) "Effective systemic risk regulation;" (2) "Strong capital standards;" (3) "Meaningful and consistent consumer protection;" (4) "Increased national uniformity through either a federal charter or effective action by the states;" (5) "Improve and broaden the regulation of insurance company[y] affiliates;" and (6) Better "[i]nternational coordination." *Id.* at 40-41. The first five principles are

(A) the increase in capital requirements for financial services entities that have been designated as Tier 1 Financial Holding Companies; and (B) the creation of additional regulatory standards for insurance companies.

# A. Increased Capital Requirements For Tier 1 Financial Holding Companies

The White Paper attempts to achieve the goal of promoting robust and comprehensive supervision through the creation of a systemic risk regulator.<sup>38</sup> If an insurer is designated as a potential systemic risk to U.S. financial system, the White Paper proposes an increase in the company's capital requirements, likely to a standard greater than required of its subsidiary depository institutions.<sup>39</sup>

#### 1. Systemic Risk Regulation

The creation of a systemic risk regulator is of most significance to large insurance focused entities because the systemic risk regulator regulations would only apply to firms designated as Tier 1 Financial Holding Companies ("Tier 1 FHCs"). A financial services company would be a Tier 1 FHC if its "material financial distress [would] pose a threat to global or United States financial stability or the global or

implicitly discussed in this note. Item one is discussed *infra* Parts III.A.1 and III.B.2. Item two is discussed *infra* Part III.A.1. Item three is discussed *infra* Part III.B.3. Items four and five are discussed *infra* Parts III.A.1, III.B.1, and Part III.B.2.

White Paper, supra note 2, at 3.

<sup>39</sup> Id. at 24.

United States economy."40 The regulator's role would be to propound Tier 1 FHC prudential standards [that are] more stringent than the standards applicable to bank holding companies."41

Under the Tier 1 FHC proposal, activities and services regulated under existing law would continue to be overseen by the existing regulator, but would also be subject to higher capital, liquidity, and risk management standards enforced by the Federal Reserve. Foreign and domestic subsidiaries of Tier 1 FHCs would also be subject to consolidated prudential regulation by the Federal Reserve. Foreign firms identified as Tier 1 FHCs would have currently unregulated activities in their U.S. and foreign subsidiaries subjected to consolidated examination and evaluation. 43

Designation of Tier 1 FHCs would be conducted by the newly created Financial Services Oversight Council ("FSOC"). 44 The FSOC

Exec. Prop. Legislation, Title II—Consolidated Supervision and Regulation of Large, Interconnected Financial Firms sec. 204, § 6(a)(1)(A) (proposed 2009), available at http://www.financialstability.gov/docs/regulatoryreform/07222009 /titleII.pdf [hereinafter Title II]. Portions of the Obama Administration's proposed draft legislation have been codified in House Resolution 3996 and House Resolution 4173. Financial Stability Improvement Act of 2009, H.R. 3996, 111th Cong. (2009); Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

<sup>&</sup>lt;sup>41</sup> Title II, *supra* note 40, sec. 204, § 6(c)(1).

Sullivan & Cromwell LLP, Financial Services Regulation, June 17, 2009, at 2, available at http://www.sullcrom.com/files/Publication/70a3856b-b7b2-4fef-8c0e-02e25f6171e7/Presentation/PublicationAttachment/88a926ed-897c-4305-8a26-04c7d1d9542e/SC\_Publication\_Financial\_Services\_Regulation.pdf [hereinafter Sullivan June 2009].

White Paper, supra note 2, at 10-12.

<sup>44</sup> Id. at 24.

would have representation from major financial regulatory agencies and would be headed by the Treasury Department.<sup>45</sup> The FSOC would identify firms that are of a "combin[ed] size, leverage, and interconnectedness [that their failure] could pose a threat to financial stability."46 In 2007, Chairman Ben Bernanke, speaking on behalf of the Federal Reserve, stated that financial crisis "can involve significant and unpredictable interdependencies across institutions, markets, and the real economy."47 If Chairman Bernanke's view that interdependencies can be unpredictable is indicative of the FSOC's approach, markets could assume that the FSOC will be relatively inclusive when defining the list of Tier 1 FHCs because such an approach would more likely result in regulatory oversight of any unpredictable interdependencies. The insurance industry would have input to the FSOC's decision making process through the newly proposed Office of National Insurance ("ONI").48 While the ONI would not be a member of the FSOC, under the White Paper, the Obama Administration "envisions that [the ONI] could recommend to the Federal Reserve that a particular insurance company be supervised as a Tier 1 FHC."49 Further, the American Council of Life Insurers

- 45 Id. at 10 (Membership of the FSOC consists of: "(i) the Secretary of the Treasury, who shall serve as the Chairman; (ii) the Chairman of the Board of Governors of the Federal Reserve System; (iii) the Director of the National Bank Supervisor; (iv) the Director of the Consumer Financial Protection Agency; (v) the Chairman of the SEC; (vi) the Chairman of the CFTC; (vii) the Chairman of the FDIC; and (viii) the Director of the Federal Housing Finance Agency (FHFA).")
- <sup>46</sup> *Id*.
- <sup>47</sup> Gov. Ben S. Bernanke, Federal Reserve Board, Remarks at The Allied Social Science Association. (Jan. 5, 2007).
- 48 See discussion of ONI infra Part III.B.1.
- <sup>49</sup> Sullivan June 2009, supra note 42, at 6.

("ACLI") has proposed amendments making the ONI a member of the FSOC to give "ONI parity with other Treasury offices" and to "[a]ssure[] that the FSOC has insurance expertise . . . . "50

Presuming the list of Tier 1 FHCs will be made public,<sup>51</sup> the exact consequences of "stricter and more conservative" "capital, liquidity, and risk management standards" <sup>52</sup> to insurance companies are unclear, but two possible scenarios are defined by analysts. The first possible impact to an insurance-focused financial company could be defacto recognition of firms which are "too big to fail," and the implicit federal guarantee of debt.<sup>53</sup> If such an implicit guarantee is

Stephen E. Rahn, Overview of the American Council of Life Insurers (ACLI) Proposed Amendments to the U.S. Treasury Financial Reform Proposals for Titles I, II, III, V, VI and XII, ALI-ABA Course of Study Materials, SR020 ALI-ABA 217 (Nov. 2009).

The U.S. House Financial Services Committee's October 27, 2009 draft of White Paper inspired legislation prohibits public release of "identified financial holding companies," the draft legislation's equivalent term for Tier 1 FHC. Sullivan & Cromwell LLP, House Financial Services Committee Draft Financial Regulatory Reform Legislation, Nov. 2 2009, at 3, available at http://www.sullcrom.com/files/Publication/dc724a71-74af-424e-9d71-1041a06573 b6/Presentation/PublicationAttachment/0790b7c0-5914-44e4-bce7-10454b8291b8/SC\_Publication\_House\_Financial\_Services\_Committee\_Draft\_Financial\_Regulatory\_Reform\_Legislati.pd f [hereinafter Sullivan Nov. 2009]. However, "publicly-traded companies designated as IFHCs could be subject to certain related disclosure obligations arising under the federal securities laws." Id.

<sup>52</sup> White Paper, supra note 2, at 10.

<sup>53</sup> Systemic Risk: Are Some Institutions Too Big to Fail and If So, What Should We Do About It? Hearing on Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals Before the H. Comm. on Financial Services, 110th Cong. 3-5 (2009) (statement of Testimony of Paul G. Mahoney, Dean, University of Virginia School of Law), available at http://www.house

inferred by the markets, entities identified as Tier 1 FHC issuers could be assessed as very low risk. <sup>54</sup> The anticipated low risk could encourage capital investment in these entities at lower than market returns, consequently reducing capital costs to Tier 1 FHCs and strengthening their implicit guarantee. <sup>55</sup> The result could compromise the Administration's overall goal of reducing the economy's exposure to the failure of a Tier 1 FHC. <sup>56</sup> In response, the Federal Reserve might increase prudential capital requirements to higher than necessary to safeguard against entity failure, instead setting capital requirements sufficiently high to function as a market handicap. The Federal Reserve's goal would likely be to set capital requirements to counter the implicit federal guarantee and prevent negative market distortions. <sup>57</sup> Therefore, Tier I FHCs could be required to meet prudential standards higher than is reasonable against failure or

gov/apps/list/hearing/financialsvcs\_dem/mahoney.pdf [hereinafter Mahoney] ("[I]nstitutions anticipate that they will be able to shift some or all of their losses to taxpayers.")

- Id. But see Press Release, U.S. Dep't of Treasury, Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms (Sep. 3, 2009), available at http://www.treas.gov/press/releases/docs/capital-statement\_090309.pdf [hereinafter Principles for Reform] (Without a framework to minimize the effect, higher capital and liquidity requirements, in particular, are "likely to incent the migration of financial transactions away from the banking sector into the non-bank sector.")
- Mahoney, supra note 53, at 5. See generally Baily, supra note 26 ("We do not want to expand the number of financial institutions that carry an implicit guaranty that they will not be allowed to fail.")

<sup>54</sup> Id.

<sup>&</sup>lt;sup>57</sup> Mahoney, supra note 53, at 6.

collapse, but consistent with limiting market appeal for their debt. Under this alternative, the consequences of the designation would depend on the ability of the Federal Reserve to limit appeal of the Tier 1 FHCs debt.<sup>58</sup>

A near opposite alternative outcome of designating firms as Tier 1 FHCs could be that increased capital requirements would drive investment away from Tier 1 FHCs long-term investments.<sup>59</sup> Increasing capital adequacy requirements could impact the "boundary interaction" between the banking and non-banking financial sectors.<sup>60</sup> While boundary interaction is usually considered with respect to money market mutual funds, derivative transactions, and securitization markets,<sup>61</sup> a similar analog could be made to the insurance industry. While some insurance industry products, such as securities-based variable annuities, function in the financial, non-banking sectors<sup>62</sup> and are regulated by the SEC,<sup>63</sup> unlike the other

<sup>58</sup> Id. (Mahoney believes that the Federal Reserve would be unable to reduce demand for debt issued by firms designated Tier 1 FHCs.)

<sup>59</sup> See generally Principles for Reform, supra note 55, at 1. (Higher capital and liquidity requirements, in particular, "is likely to incent the migration of financial transactions away from the banking sector into the non-bank sector.")

<sup>60</sup> Id. at 12-13.

<sup>61</sup> Id. at 13 (observing that the "Federal Reserve and the Financial Services Oversight Council ("FSOC") will be explicitly charged with monitoring threats to financial stability . . . from any quarter" and identifying money market mutual funds, derivative transactions, and securitization markets).

<sup>[</sup>S]ecurities-based variable annuities and other variable insurance products . . . were created to compete with mutual funds that were draining funds away from whole life and annuity insurance." Jerry W. Markham, Mutual Fund Scandals - A Comparative Analysis of The Role of Corporate Governance in the Regulation

financial services providers, most insurance providers still primarily answers to the several states.<sup>64</sup> This unique regulatory structure could provide opportunities,<sup>65</sup> or risk,<sup>66</sup> for insurance companies that are not

of Collective Investments, 3 HASTINGS BUS. L.J. 67, 144 (2006), construing SEC v. United Ben. Life Ins. Co., 387 U.S. 202, 212 (1967).

- Assets that shift risk to the investor "had to be held in separate accounts that were subject to SEC requirements" to prevent state regulators from basing reserve requirements "on the type of contract, age of issue, and mortality and interest assumptions involved." Markham, supra note 62, at 144-45 (quoting Investigation of Concentration of Economic Power: Hearing Before the Temp. Nat'l Econ. Comm., 76th Cong., Monograph No. 28 (1940)) (construing Prudential Ins. Co. of America v. SEC, 326 F.2d 383, 388 (3d Cir. 1964) (internal quotations removed)).
- As determined by a search of major insurers' Federal Reserve filings at the National Information Center website (NIC), thirteen of the fourteen large traditional insurance companies are not currently classified as financial or bank holding companies. The National Information Center ("NIC") Home Page, http://www.ffiec.gov/nicpubweb/nicweb/NicHome.aspx [hereinafter NIC Website]. Financial or bank holding company status triggers consolidated Federal Reserve review. Report on GLB Act, supra note 22. In lieu of consolidated Federal Reserve regulation, state insurance regulations often predominate. See White Paper, supra note 2, at 35 ("the OTS does not impose any capital requirements on thrift holding companies, such as AIG).
- 65 See Cunningham et al, supra note 1, at 101 ("A potentially appealing result of this fragmentation of authority is a palette of options for participants in financial markets.")
- 66 Principles for Reform, *supra* note 55, at 13. (concluding that "vigilance is required" to prevent any regulatory advantage gained by the non-banking financial sector from transforming into increased systemic risk).

identified as Tier 1 FHCs, as those companies would be subject to a unique combination of regulators.<sup>67</sup>

#### B. Increased Federal Oversight of Insurance Companies

The second broad impact of the White Paper's proposed solution to "promote robust supervision and [p]rotect consumers and investors from financial abuse"<sup>68</sup> is increasing federal oversight of insurance companies. The insurance industry would be impacted in three ways: <sup>69</sup> by the creation of an Office of National Insurance; <sup>70</sup> by applying some of the regulatory standards that apply to bank holding companies

Insurance companies without international banking links are also exempt from the Basel II banking requirements. Basel Comm. on Banking Supervision, Int'l Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2006), Art. II § 24 & 7 n.6, available at http://www.bis.org/publ/bcbs128.htm [hereinafter Basel II Convergence Framework] ("To the greatest extent possible, [all financial activities related to an international bank] will be captured through consolidation; [however] [f]inancial activities do not include insurance activities [or] entities.")

<sup>68</sup> White Paper, supra note 2, at 3.

The White Paper also recommends the registration of hedge funds, strengthening money market mutual funds, creation of additional regulation of over the counter derivatives, harmonization of futures regulations, and improvements in payment clearing systems; however, these changes are not as likely to have as substantial an impact on the insurance industry. *Id.* at 12-15.

<sup>&</sup>lt;sup>70</sup> *Id.* at 39.

to thrift holding companies;  $^{71}$  and by the creation a Consumer Financial Protection Agency.  $^{72}$ 

#### 1. Office of National Insurance

The proposed Office of National Insurance ("ONI") does not appear to be an effort to fundamentally change the primacy of state regulators. However, the ONI's role in "identifying the emergence of potential regulatory problems or gaps that could contribute to a financial crisis" will increase Federal oversight. Early Obama administration pronouncements regarding Federal preemption of state law indicated reluctance to preempt absent a specific regulatory need. For example, within his first one hundred days, Obama issued a memorandum directing administrative agencies to refrain from broadly claiming preemption unless sufficient legal basis for the

<sup>&</sup>lt;sup>71</sup> *Id.* at 12.

<sup>&</sup>lt;sup>72</sup> *Id.* at 14.

<sup>&</sup>quot;Nothing in this section shall . . . preempt any State insurance measure that governs any insurer's rates, premiums, underwriting or sales practices, or State coverage requirements for insurance, or to the application of the antitrust laws of any State to the business of insurance." Exec. Prop. Legislation, Title V—Office of National Insurance (proposed 2009), at § 313(i), available at http://www.financialstability.gov/docs/regulatoryreform/07222009/title%20V%20Ofc%20Natl%20Ins%207-22-2009%20fnl.pdf [hereinafter Title V].

Sidley Austin LLP, The Administration's Financial Regulatory Reform Proposals, FINANCIAL REGULATORY REFORMS UPDATE, June 18 2009, at 1, available at http://www.sidley.com/files/News/ee06cf71-25dc-4162-8032-79d5fd7d0e78/ Presentation/NewsAttachment/9b4fed91-b9b6-495c-8afc-7ce09f5b3532/FSR-Update.pdf.

preemption exists.<sup>75</sup> So, based on previous administration policy, an observer could expect the ONI to supplement, not replace, existing state regulation.

Other recent efforts to supplement federal regulatory oversight have also focused on harmonization of state regulatory standards with international agreements. For example, the Treasury Department's Office of Insurance Information ("OII") proposal outlined in *Blueprint for a Modernized Financial Regulatory Structure* would have been responsible for "(1) exercising statutory authority to address international insurance regulatory issues, including policy on reinsurance collateral requirements; and (2) advising the Treasury

Presidential Memorandum for the Heads of Executive Departments and Agencies, 2009 Daily Comp. Pres. Doc. 00384 (May 22, 2009), available at Memorandum for the Heads of Executive Departments and Agencies, 74 Fed. Reg. 24693 (May 22, 2009) (Two justifications are provided in the memo: (1) specifically allowed in codified regulation (2) "under the legal principles governing preemption, including . . . Executive Order 13132.")

Dewey & LeBoeuf, Federal Office of Insurance Information (OII) Proposal Examined by Capital Markets Subcommittee, CLIENT ALERT, June 11, 2008, at 2, available at http://www.deweyleboeuf.com/~/media/Files/clientalerts/Federal OfficeofInsuranceInformationOIIProposalExaminedbyCapitalMarketsSubcommit tee.ashx [hereinafter Dewey June 2008].

A partial implementation of some of the Blueprint's insurance proposals was introduced in House Resolution 5840 (2008). Insurance Information Act of 2008, H.R. 5840, 110th Cong. (2008).

The amount of required to be held, by statute, by "an insurance company for the protection of its policyholders, such to be applied in the event of the insolvency or dissolution of the company to the reinsurance of outstanding risks carried by the company." Ballentine's Law Dictionary (Lexis 2010) (definition for reinsurance reserve).

Secretary on major domestic and international insurance policy issues,"<sup>79</sup> as opposed to altering state regulation. However, some later insurance regulatory reforms have become more focused on developing a significant federal regulatory power. For example, proposed amendments to House Resolution 5840<sup>80</sup> allowed preemption of state law, and House Resolution 6213<sup>81</sup> proposed Federal certification of state regulatory efforts in the area of reinsurance.

While the ONI's role is only broadly defined, the White Paper and draft legislation does appear to move further in the direction of federal power by raising the possibility ONI creating a federal insurance charter or increasing monitoring of affiliates.<sup>82</sup> The creation of federal insurance charter would be the most significant change to the insurance industry; however, the White Paper and the associate proposed legislation do not forward a substantive proposal for a federal charter. <sup>83</sup> Further, the national insurance charter has been met with skepticism. <sup>84</sup> Therefore, even if the enacted legislation required what

Dewey June 2008, *supra* note 76, at 2 (internal quotations removed).

Insurance Information Act of 2008, H.R. 5840, 110th Cong. (2008) (Proposed legislation to implement a federal office of Office of Insurance Information with the Department of the Treasury.)

Reinsurance International Solvency Standards Evaluation Board Act of 2008, H.R. 6213, 110th Cong. (2008) (Proposed legislation to establish a federal reinsurance supervisor.)

White Paper, supra note 2, at 40.

The White Paper called for "[i]Increased national uniformity through either a federal charter or effective action by the states," but did not propose a detailed federal charter. *Id.* 

<sup>&</sup>quot;I think really what we need to focus on is systemic risk and get to the rest of these regulatory changes later." Mark A. Hofman, National Insurance

the White Paper terms effective action by the states, the ONI would probably not significantly increase regulatory oversight effort.

2. Increased Oversight Regardless of Status as Bank Holding Company

The White Paper proposes eliminating many of the regulatory distinctions between thrift holding, bank holding, and other non-traditional companies engaging in banking activities. The White Paper achieves this goal by eliminating both the Office of Thrift Supervision ("OTS") and the Office of the Comptroller of the Currency ("OCC"), and merging their respective functions into a single National Bank Supervisor.<sup>85</sup> A possible significant impact of this change is widening the applicability of restrictions on bank holding companies conducting non-financial business. The Bank Holding Company Act

Regulatory System Proposed, INVESTMENT NEWS, February 22, 2009, http://www.investment news.com/article/20090222/REG/302229983 (quoting Senior Vice President of the Property Casualty Insurers Association of America Ben McKay). National Association of Professional Insurance Agent's Executive Vice President & CEO Len Brevik opining in 2006, that "[t]here is no evidence that the state-based system of insurance regulation is broken or in need of a Congressional fix." Brevik Blasts Optional Federal Charter Bill During NCOIL Panel, http://www.pianet.com/IssuesOfFocus/HotIssues/modernization/8-1-06-Connection.htm (last visited May 1, 2010).

Exec. Prop. Legislation, Title III— Improvements to Supervision and Regulation of Federal depository institutions (proposed 2009), § 321, available at http://www.financialstability.gov/docs/regulatoryreform/title-III\_Natl-Bank-Supervisor\_072309.pdf [hereinafter Title III]. The proposed draft legislation has been introduced, in part, in both House Resolutions 3996 and 4173. Financial Stability Improvement Act of 2009, H.R. 3996, 111th Cong. (2009); Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

prohibits bank holding companies from engaging in non-financial business<sup>86</sup> and both the White Paper<sup>87</sup> and Title III<sup>88</sup> of the draft legislation would apply these same limitations to parent companies holding non-bank<sup>89</sup> banks. The elimination of these distinctions would apply Bank Holding Act non-bank activity limitations to the parent holding company. This elimination could likely lead to refinement of capital requirements and a divesture of non-financial business.

However, the exemption would not likely have a significant impact on insurance companies, as the White paper does not seek to revise the ability of Bank Holding Companies to engage in insurance related activities. Further, later House revisions of the bill realize the White Paper's goal of creating common treatment of federally insured banks, but would still allow non-finance companies that engage in banking-like activities to consolidate all banking-like activities in an intermediate section-six holding companies. <sup>91</sup> Under

<sup>86</sup> Bank Holding Company Act of 1956, ch. 240, § 4(a), 70 Stat. 133, 135 (codified at 12 U.S.C. § 1843(a)).

White Paper, supra note 2, at 34.

<sup>88</sup> Title III, *supra* note 85, at § 321(b)(3)(B).

White Paper, *supra* note 2, at 34 ("industrial loan companies, credit card banks, trust companies, and grandfathered 'nonbank' banks").

Title V, supra note 73, at § 313(i). For a historical context of the enforcement of the Bank Holding Act prior to the GLB Modernization Act, see the Federal Reserve's refusal to allow Transamerica Corporation to integrate Occidental Life Insurance Company. See Generally J. Nellie Liang, Donald T. Savage. The Nonbank Activities of Bank Holding Companies, Federal Reserve Bulletin, May 1990.

<sup>91</sup> Sullivan Nov. 2009, supra note 51, at 4.

this financial structure, the House legislation would permit non-banking activities to occur at the parent company. This structure may be beneficial for insurance companies which have other non-insurance, non-banking activities. The later House revisions also differ from the White Paper by opting to fold the OTS into a larger OCC. 93

In addition to the restrictions on non-banking activities, changing the primary regulator, would impact insurance companies depending on their current regulatory structure. First, today, only one of the fourteen large traditional insurance companies is classified as bank holding or financial holding companies. <sup>94</sup> This entity is already subject to consolidated regulation by the Federal Reserve, and the change to its regulation would likely only be an increase in prudential

<sup>92</sup> Id.

<sup>93</sup> Systemic Regulation, Prudential Matters, Resolution Authority and Securitization: Hearing on Discussion Draft of H.R. 3996, The Financial Stability Improvement Act of 2009 Before the H. Comm. on Financial Services, 110th Cong. 5 (2009) (statement of John E. Bowman, Acting Director, Office of Thrift Supervision) ("The discussion draft represents a significant departure from the Administration's [W]hite [P]aper on Financial Regulatory Reform and the original legislative language [by acting to] preserve the OCC and create within the OCC a new Division of Thrift Supervision."

Met Group (MetLife, Inc.). As determined by a search of major insurers' Federal Reserve filings at the National Information Center website (NIC). NIC Website, supra note 64. Hartford Financial Services Group and Lincoln National Group were approved to become Bank Holding Companies in 2009; however, the National Information Center does not show that process as completed. John Poirier et al, U.S. Approves The Hartford, Lincoln National Bank Holding Company Bids, INSURANCE JOURNAL, Jan. 12, 2009, available at http://www.insurancejournal.com/news/national/2009/01/12/96858.htm.

capital requirements should the systemic risk regulator legislation become law and it was identified as Tier 1 FHC.

Second, thirteen<sup>95</sup> of the fourteen large traditional insurance companies are not currently classified as either financial or bank holding companies, as such, the GLB Act requirement for Federal Reserve consolidated supervision is not triggered.<sup>96</sup> Some insurance-focused financial companies that are structured in this way own thrifts or savings banks.<sup>97</sup> Financial firms that own thrifts or savings banks are, instead, regulated under the Office of Thrift Supervision's consolidated regulation which does not impose capital requirement on the holding company.<sup>98</sup> The White Paper propounds that "[a]ll companies that control an insured depository institution, however organized, should be subject to robust consolidated supervision and regulation at the federal level by the Federal Reserve." <sup>99</sup> As such,

American Intl Group, ING America Insurance Holding Group, Lincoln National Group, Axa Insurance Group, TIAA Family Group, Prudential of America Group, Aegon U.S. Holding Group, Jackson National Group, New York Life Group, Northwestern Mutual Group, Mass Mutual Life Insurance Group, Hartford Fire & Casualty Group, and John Hancock. NIC Website, supra note 64.

<sup>96</sup> Report on GLB Act, supra note 22.

The highest profile insurance company in this group is AIG, which owned a savings bank subject to consolidated regulation. *International Law and The Economic Crisis: The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581, 603 & 638 n.91 (2010).

<sup>98</sup> White Paper, supra note 2, at 35.

Id. at 34 (The White Paper identifies "companies that own an FDIC-insured thrift, industrial loan company (ILC), credit card bank, trust company" as well as "some investment banks, . . . insurance companies, . . . finance companies, commercial companies, and other firms" as having been able to avoid the BHC Act; but by the White Paper's terms, insured state member banks, state non-

under the White Paper proposal, these companies would be subject to new prudential, consolidated regulation by the Federal Reserve. Finally, insurance companies that are neither Financial Holding nor Bank Holding companies, and do not own a thrift or savings bank, are primarily subjected to state regulation. These companies would only be subjected to new regulation if designated Tier 1 FHCs.

Regardless of the mechanism that triggers new prudential consolidated regulation, two potential impacts would result from a change in primary regulator: (1) alternation of technical regulatory standards; and (2) the development of new administrative procedures. First, technical regulatory standards will vary. For example, while the statutory and regulatory requirements of bank and finance holding companies are substantially similar, particularly regarding capital adequacy, many minor technical variations exist in implementation. One of these variations result from statutory remnants that cannot be resolved by agency harmonization efforts, while others result from

member banks, federal Credit Unions, Savings & Loan Associations (S&L), and Federal Savings Banks (FSB) could also be impacted.

See NIC Website, supra note 64; McCarran-Ferguson Act, ch. 20, 59 Stat. 33, 34 (1945) (codified at 15 U.S.C. § 1012-(a) (2009)). Additional non-consolidated regulation of securities based investments may be conducted by the SEC. White Paper, supra note 2, at 12 (proposing elimination of the SEC consolidated supervision programs).

See Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies; Report to Congressional Committees, 73 Fed. Reg. 50,327 (Aug. 26, 2008) [hereinafter Joint Report] ("The federal banking agencies have substantially similar capital adequacy standards."). See 12 U.S.C. § 4803 (a) (2009) ("[E]ach Federal banking agency shall. . . work jointly with the other Federal banking agencies to make uniform all regulations and guidelines implementing common statutory or supervisory policies.")

inconsistent regulatory efforts.<sup>102</sup> Yet other variations result from "case specific inquiries that have only been presented to one agency."<sup>103</sup> As such, technical standards can be expected to vary more broadly when more dissimilar categories are aggregated to Federal Reserve supervision.

Second, the transfer of examination and compliance efforts to either a new, or newly-created, governmental body creates additional complexities. In particular, the potential for a new consolidated, prudential regulator draws a parallel with European experiences with large consolidated regulators. 104 A pertinent example is the introduction of a unified regulator in the United Kingdom. An analysis of the introduction of the Financial Services Authority ("FSA") indicated the need for "sound regulatory / supervisory development and sophistication, the existence of quality transparent and fair administration procedures, the presence of a sound enforcement system, and the embedding of a well-trained and developed

Examples include regulatory capital treatment standards for: (1) financial and non-financial subsidiaries; (2) collateralized transactions; (3) noncumulative perpetual preferred stock; (4) equity securities of government-sponsored enterprises; (5) tangible capital requirements; (6) market risk rules; (7) pledged deposits and nonwithdrawable accounts; (8) net worth, mutual capital and income capital certificates; and (9) FDIC insurance covered assets. Joint Report, supra note 101, at 50,327-28.

<sup>103</sup> Id.

<sup>104</sup> See Joseph J. Norton, Global Financial Sector Reform and the Mega-Regulator Issue, 39 INT'L LAW. 15, 15 n.245 (2005) (Arguing that a single integrated regulator could offer "greater supervisory efficiency" before suggesting advantages to the alternatives.)

judiciary."<sup>105</sup> While the United States regulatory system has significant development and sophistication, the development of newly integrated administrative procedures for both domestic and foreign activities could be challenging. For insurance-focused financial services companies that have been identified as Tier 1 FHCs, the regulatory requirement to undergo a top to bottom consolidate examination of all U.S. and foreign financial activities changes will be significant. Overall, regardless of the final form of reform, insurance companies engaging in banking-like activities regulated by the Office of Thrift Supervision ("OTS"), the Office of the Comptroller of the Currency ("OCC"), or the National Credit Union Administration ("NCUA") will likely need to meet additional legal requirements currently applied exclusively to bank holding companies. <sup>106</sup>

# 3. Increased Compliance Efforts with Consumer Protection Legislation

Finally, the White Paper and associated draft legislation is meant to "[p]rotect consumers and investors from financial abuse." <sup>107</sup> The goal of the proposal and draft legislation is not to directly alter regulation of the insurance or financial services industry, but to increase oversight of financial products offered to consumers. <sup>108</sup> In fact, traditional core-insurance businesses are exempt from further

<sup>105</sup> Id. (Speaking of a "need to mesh with the existing regulatory, economic, social, and cultural environments of the particular domestic jurisdiction.")

<sup>106</sup> See White Paper, supra note 2, at 32.

<sup>107</sup> Id. at 3.

<sup>108</sup> Title X, supra note 32, at § 1021.

regulation under a separate provision. 109 However, the legislation authorizes the newly created Consumer Financial Protection Agency ("CFPA") to regulate insurance company activities that would be under the purview of the CFPA if conducted by a non-insurance company. 110 As such, traditional insurance company businesses may be impacted in three categories: (1) impact to non-insurance businesses that support insurance products; (2) impact to non-insurance businesses that do not support insurance products; and (3) impact to federally insured banking.

First, non-insurance products that support insurance products such as investing advice for annuity products would be impacted by the White Paper's definition of financial services and products, which include: (1) acting as an investment adviser; (2) acting as a financial investor; (3) collecting of debt related to any consumer financial product or service. <sup>111</sup> Proposed Title X extends CFPA regulations to both traditionally regulated and unregulated investment advisors. <sup>112</sup> Even under the original proposal, many insurance company employees

<sup>&</sup>lt;sup>109</sup> Title X, *supra* note 32, at § 1021(18)(O).

<sup>110</sup> Satish M. Kini and Thomas S. Wyler, *The Consumer Financial Protection Agency: For Better or Worse, a Work in Progress*, DEBEVOISE & PLIMPTON FINANCIAL INSTITUTIONS REPORT, November, 2009, at 1, available at http://www.debevoise. com/files/Publication/79739de3-a6ef-43be-aff8-88176a0ac7a5/Presentation/ PublicationAttachment/194582cc-27ea-43cd-9e54-912985aa5bab/FIReport November2009.pdf [hereinafter Debevoise Nov. 2009].

Title X, supra note 32, at § 102(18) (a complete list of the financial activity includes fifteen parts, including activities defined by the administrating agency).

Original House resolutions covered some "financial advisors" as far removed from the financial services industry as auto dealers. This provision was removed from the December 11, 2009 version of House Resolution 4173. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

and agents would have been exempted because the White Paper had excluded "investment advisors registered with Securities and Exchange Commission (the "SEC") or the Commodities Futures Trading Commission" from the CFPA's authority. 113 However, later legislative revisions now make it unlikely that even the provisions allowing CFPA regulation of investment advisors would have a meaningful impact on insurance industry because House Resolution 3126 also exempts investment advisor regulated by the several states. 114 As insurance agents are regulated by state authorities, 115 and many other insurance industry financial advisors are regulated by the SEC, the addition of this exemption may cover many or most direct and indirect industry employees. Second, products that are independent of the core insurance business are more likely to see changes to consumer protection law. One area that impacts a number of insurance companies is real estate services. The CFPA Act subjects investment advisors involved in real estate settlement services, title insurance, or agent and brokerage services to CFPA jurisdiction. 116

Third, while Title X shifts some financial-advisor consumer protection power from state regulators to the federal CFPA, Title X simultaneously shifts power in opposite direction for some federally charter banking companies. Title X augments existing federal

<sup>113</sup> Debevoise Nov. 2009, supra note 110, at 1.

<sup>&</sup>lt;sup>114</sup> Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. (2009).

<sup>115 1-2</sup> New Appleman on Insurance Law Library Edition § 2.02 ("All states impose licensing requirements on insurance agents and brokers."). See generally LexisNexis 50 State Surveys, Legislation & Regulations, Insurance Agents & Adjusters (December 2008) (A list of state statutes which regulate insurance agents and adjusters.)

<sup>116</sup> Title X, supra note 32, § 1002(18).

consumer protection enforcement power with state regulation which was formally preempted. 117

Arguably, the most significant provision of Title X for operators of federal-insured banking services providers is that "state consumer protection laws" "will now apply to national banks and federal thrifts." <sup>118</sup> Currently, at least six <sup>19</sup> insurance companies that own savings banks or thrifts are only required to comply with the National Bank Act <sup>120</sup> ("NBA") and the Home Owners Loan Act ("HOLA"). <sup>121</sup> These acts provide a common set of minimal consumer protection laws that preempt consumer protection laws in the several states. Requiring compliance with state consumer protection laws, as

Sonnenschein Nath & Rosenthal LLP, The Obama Administration's Financial Regulatory Reform Plan - The Consumer Financial Protection Agency: The Erosion of Federal Preemption in Heightened Regulatory Environment, FINANCIAL CRISIS SPECIAL SITUATIONS GROUP CLIENT ALERTS, July 16, 2009, at 2, available at http://www.sonnenschein.com/pubs/pub\_detail.aspx?id=52882&type=E-Alerts [hereinafter Sonnenschein].

<sup>118</sup> Id

American International Group, ING America Insurance Holding Group, Lincoln National Group, TIAA Family Group, Northwestern Mutual Group Mass Mutual Life Insurance Group, Prudential Financial, Inc. NIC Website, supra note 64.

<sup>&</sup>lt;sup>120</sup> An Act to Provide a National Currency (National Bank Act), ch. 106, 13 Stat. 99 (1864) (codified as amended at 12 USCS § 21 et seq. (2009)); Beneficial Nat'l Bank v. Anderson, 539 U.S. 1 (2003) (holding that the National Bank Act "provides exclusive cause of action for usury against national banks, and state law action is completely preempted).

<sup>&</sup>lt;sup>121</sup> Home Owners' Loan Act of 1933, ch 64,, 48 Stat. 128 (codified as amended in scattered statutes); Sonnenschien, *supra* note 117, at 2.

proposed in the CFPA, would require compliance with a range of advertising, offering, and loan structuring laws already enacted at the state level.<sup>122</sup>

#### CONCLUSION

If significant portions of the Obama Administration's White Paper and draft legislation proposals are implemented as envisioned, the likely impact will be higher prudential capital requirements for insurance companies designated as Tier 1 FHCs due to the possibility that they pose a threat to financial stability. In addition, insurance companies which are not currently structured as a bank or financial holding company, but that have non-bank, banking operations, could be subject to consolidated federal regulation under the original White Paper proposal. Finally, non-insurance subsidiaries that offer financial services which can be offered by companies not regulated as insurance companies, may be subject to new consumer regulation, despite the parent company's exemption from CFPA regulations. In total, the White Papers regulations appear less likely to make significant impacts on the insurance industry than on other similarly sized financial services companies.

Sonnenschien, supra note 117, at 2. See JIM CHESSEN, AM. BANKERS ASSOC, FUNDING AND STAFFING THE NEW CONSUMER FINANCIAL PROTECTION AGENCY 6 (2009), available at http://www.aba.com/NR/rdonlyres/3472800B-813E-4EEE-B62D-BFBA50A46137/63648/FundingofFederalAgencies.pdf ("There are few synergies to be obtained from the creation of a new agency; rather the move will be duplicative, since two agencies will be performing the functions currently done by one.")

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